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

- … Three dots indicate that data are not available or are not separately reported.
- (–) A dash indicates that the amount is nil or negligible.
- A blank space in a table means that the item in question is not applicable.
- (-) A minus sign indicates a deficit or decrease, unless otherwise specified.
- (.) A point is used to indicate decimals.
- (/) A slash indicates a crop year or fiscal year; e.g., 2004/2005.
- (-) Use of a hyphen between years (e.g., 2004-2005) indicates reference to the complete period considered, including the beginning and end years.

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

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Summary

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Celso Furtado's contributions to structuralism
and their relevance today

Ricardo Bielschowsky

This article examines Celso Furtado's three main analytical contributions to structuralism: (i) the historical-structural method, which incorporates the histories of Brazil and other Latin American countries in structuralist formulations; (ii) the belief that underdevelopment in the Latin American periphery has tended to persist over long periods owing to the difficulty of overcoming underemployment and to inadequate diversification of production; and (iii) the idea that the pattern of investments in the periphery is predetermined by the composition of demand, which mirrors and tends to preserve income and wealth concentration. Events in Latin America in the past twenty-five years show that Furtado's analysis has lost none of its relevance.

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I

Introduction

This brief study outlines Celso Furtado's main contributions to structuralism, that is, to the theory of peripheral development developed by Raul Prebisch and ECLAC, and discusses why Furtado's important analytical contributions to Latin American and Brazilian debate on growth and development has had such a strong intellectual and ideological impact, especially in Brazil. A look at the main trends in Latin America and Brazil between 1980 and 2005 in the light of Furtado's contributions, which were written almost half a century ago, reveals how overwhelmingly up-to-date those contributions still are. This is so for unfortunate reasons, however. The levels of growth, employment and income distribution in the region in the past 25 years have confirmed Furtado's scepticism concerning the prospects for development in the absence of well-designed and properly implemented national development projects.

II

Prebisch and economic development under structural conditions of the periphery

As a prelude to examining Furtado´s contributions, it is necessary to turn briefly to Prebisch and his theory of peripheral conditions of development with respect to Latin America.[1] This is because Furtado was a follower of Prebisch –the founder of Latin American structuralism– and because Prebisch's theory is rarely adequately addressed in the literature on economic development, most references being limited to the thesis on the worsening terms of trade. As Octavio Rodriguez correctly argued in his book on ECLAC thinking,[2] Prebisch's theory constitutes an analytical corpus geared to the study of underdevelopment in Latin America.

According to this theory, constraints on growth stem from Latin America's specific position on the periphery of the developed world. Prebisch used the term "peripheral" economies in order to contrast them with the "central" economies. The main argument is that the differences between the two are associated with poor growth conditions in the periphery, which impose constraints on the industrialization process and technological progress and require growth strategies coordinated by the State, since, under those conditions, market forces are not sufficient, in themselves, to sustain viable growth.

Table 1 recapitulates the main elements of the Prebisch formulation on underdevelopment in Latin America and related problems, which was adopted by Furtado and other structuralist intellectuals.

It was on the basis of such a set of structural problems of the periphery that Prebisch and ECLAC built their analysis of growth, peripheral development and centre-periphery relations as well as their fundamental thesis: the worsening terms of trade, non-convergence between per capita income in the centre and the periphery, structural imbalance in the balance of payments, external vulnerability, saving and foreign-exchange gaps, and dynamic of the import substitution process.

In such a highly problematic environment, planning and State action were considered fundamental for sustaining industrialization and technical progress and for avoiding the perverse trends that are inherent in these conditions. For Prebisch, the main perverse trend was the structural imbalance in the balance of

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[1] Prebisch (1949) and ECLAC (1950 and 1951).

[2] See Rodriguez (1981).

TABLE 1

Latin America: Synthesis of the original structuralist theory

Features of Latin American economies	Implications for industrialization and growth
Low productive diversity	Need for simultaneous investment in many sectors –a very demanding process in terms of savings, investment and foreign exchange
Specialization in agriculture and mining	Limited capacity to generate foreign exchange due to low international demand for exports, the worsening terms of trade, and the strong demand for foreign currency generated by high income-elasticity of imports
Duality (or high degree of technological heterogeneity) –coexistence of high-productivity sectors with vast numbers of occupations that employ labour at near- subsistence levels	Low average productivity and limited surplus, as a proportion of income
Lack of appropriate institutions and business capacity	Low propensity to save and invest and insufficient capital accumulation and technological progress (part of the surplus is wasted through excessive consumption and unproductive investments)

payments; in the view of some of his followers, such as Noyola Vásquez (1957) and Sunkel (1958), there was also a structural trend towards inflation. Furtado feared both ills, but his main analytical contribution had to do with the tendency to maintain underemployment and poor income distribution.

III

Furtado's contributions to structuralism

Furtado made three major contributions to the structuralist framework. First of all, Furtado endowed structuralism with a long-term historical perspective (1959 to 1970) and showed that, throughout centuries of alternating cycles of growth and contraction (in Brazil, the sugar-cane, mining and coffee cycles), each period has generated social and economic dualities (or heterogeneities), as well as a low level of diversification of production. Furtado's book *The Economic Formation of Brazil*[3] was a clear –and very successful– attempt to point out the historical elements in the formation of Brazil that justify the use of structuralism and of its economic policy conclusions (Bielschowsky, 1995). His objective was to demonstrate that the Brazilian economy had the characteristics of low diversity and duality described by Prebisch and that problems faced by the industrialization process in the 1950s were due to the historical and structural constraints on growth resulting therefrom, hence the need for State coordination to overcome them.

Secondly, in the book "*Desenvolvimento e Subdesenvolvimento na América Latina*" (1961),[4] Furtado launched the debate on the difficulty of modern urban sectors to absorb the massive workforce streaming from countryside to city. He may have been the first to suggest that underemployment might become a long-term problem in Latin America and that the duality analysed by Lewis (1954) might persist. He was also one of the first to contend that the increase in productivity in modern sectors can coexist over a long period with low wages, thereby maintaining the poor secular distribution of income in Latin America. Furtado warned that, even if growth were sustained, it would be difficult to absorb the huge workforce available in Latin American societies; indeed, even if growth is sustained over a long period, the problems of

[3] See Furtado (1959).

[4] See Furtado (1961).

unemployment and underemployment, technological heterogeneity, income concentration and social injustice can persist.

Studies on Brazilian economic thinking[5] do not find any prior arguments to Furtado's with this content, leading to the conclusion that it was Furtado, himself, who initiated the Latin American debate on the relationship between development, wage-setting and income concentration in conditions of rural and urban underemployment.

In his 1961 publication, which is a compilation of essays written in the second half of the 1950s, Furtado probably anticipated some of the basic ideas of the dependency theories debated throughout the 1960s. In his view, the Latin American growth model is one of the legacies of the developed economies' predominance over the rest of the world, which meant that, during industrialization of the periphery, modern foreign firms and their local competitors tend to share a production system with archaic structures. This leads peripheral systems to a new form of "dual" economy, based to a large extent on inappropriate production methods for processing local resources and incapable of overcoming the underdevelopment that characterizes a considerable part of the production system.

Furtado's third major contribution to structuralism appeared some years later,[6] when he deepened his analysis of the relationship between growth and income distribution. He argued that the sectoral composition of investment and technological options were predetermined by income and wealth concentration, giving the modern fraction of the Latin American production structure a capital density similar to that of the developed countries. The technology used can help to maintain full employment and high wages in the latter, but is insufficient in Latin America to absorb the abundant labour supply and raise wages systematically. This model of investment implies maintaining unemployment, low wage levels and income concentration, which in a vicious circle, reinforces an inappropriate investment mix. Here again, he contrasted the periphery to the centre as a way of showing that, unlike what occurs in the countries of the centre, growth patterns in those of the periphery tend to preserve the abundance of labour and prevent improvements in productivity from being reflected in workers' income.

Two flaws in Furtado's analysis should be pointed out here. First, in the book he published in 1966, he stated that the Latin American growth and industrialization model showed diminishing returns, which resulted in a tendency to stagnation. Later, he had to abandon this idea, based on conclusive evidence of significant growth in the region. Second, he did not consider the possibility that birth control and a rapid growth in the existing distributive model would deplete the labour surplus. Nevertheless, none of the above can obscure the fact that Furtado –together with Maria da Conceiçao Tavares and Aníbal Pinto–[7] launched the Brazilian and Latin American debate on growth and income distribution models.

In sum, Prebisch and Furtado's analytical scheme is a historical and structural analysis of the persistent productive heterogeneity and insufficient diversification of the production structure and is an analysis of the consequences of these two characteristics for growth, employment and income distribution, which should be taken as central references for formulating and implementing reform and development agendas.

IV

Furtado's analytical contributions and current economic trends in Latin America

Statistical data on the socio-economic development of most Latin American countries in the past 25 years reveal a poor performance both in absolute terms and in comparison with the 30 previous years of State-led expansion: very low growth in GDP and productivity, much lower rates of investment, higher rates of unemployment and underemployment and income concentration rates that have not fallen despite the increase in social spending.

[5] See, for instance, Bielschowsky, 1995 and 2000.

[6] See Furtado (1966, 1968, 1972 and 2000).

[7] See Tavares (1964) and Pinto (1965).

None of this came as any surprise to Celso Furtado, who was always sceptical about the generation of growth and employment and income redistribution in Latin America in the absence of State-led growth strategies. Since the early 1980s, he maintained on different occasions that this situation was the result of inappropriate reforms, lack of new developmentalist strategies and debt policy errors, capital volatility and globalization.

Furtado was joined in this criticism by a good number of other heterodox economists who followed the same line of thinking, believing that if Latin American economies continued to follow the course set by the liberalizing reforms, they would remain trapped in a process of weak investment, low employment and sluggish growth, with wages also at low levels, poverty and income concentration. It would be beyond the scope of this essay to review the interpretations of the currents of neoliberal and heterodox thinking in Latin America; suffice it to say that Prebisch and Furtado's analytical contribution have been enriching and of great value for analysing current trends.

This point is not immediately demonstrable since Prebisch died in the 1980s, while Furtado, who addressed the issue of trends only in brief articles, did not make any systematic analysis of the pattern of Latin American economic growth in the past 25 years. To overcome this limitation, a list of statements has been drawn up that could well have been made by either of these thinkers based on the theories that they formulated.

It should be noted that such statements, which are inspired by Prebisch and Furtado, are not based on any belief that it is possible to return to the policies of the 1950s, 1960s or 1970s. Certainly, it will mean bringing alternatives to neoliberal strategies in line with the new context: the economies are open to trade in goods and services, and growth-oriented macroeconomic policies are limited by the existence of uncontrolled financial markets and by the destabilizing influence of volatile capital flows and, in many countries, by large internal and external debts. In addition, national States are now more limited in terms of the resources at their disposal and their ability to put into practice development agendas. Nevertheless, none of this detracts from the validity of Prebisch and Furtado's analytical scheme for analysing Latin American trends and prospects and formulating new growth strategies.

As far as the economic trends of the past 25 years are concerned, the following statements could perfectly well have been formulated by Prebisch and Furtado:

(i) In Latin America, the last 25 years have been a period of relative stagnation. There have been many changes, some of them positive –the end of high inflation and fiscal disequilibria and the increase in productivity in many sectors– but, on the whole, the result has been highly unfavourable, both economically and socially. This period marks the downturn of the long-term industrialization-based growth cycle, and it replicates some of the main characteristics of the downswings in past business cycles (such as agricultural and mining cycles): inadequate diversification, heterogeneity and underemployment, low returns to labour and income concentration;

(ii) With few exceptions, in most countries, economic policy and the reforms carried out contributed to a relative de-industrialization, with the loss of production chains and of inter- and intra-sectoral complementarities in the manufacturing sector. The region has witnessed a reversal of the previous trend towards productive diversification, together with a premature de-industrialization process (UNCTAD, 2003), which occurred before the region reached the stage of building up technology-intensive sectors and providing an environment conducive to a proper innovation system. This has weakened the structural foundation for growth.

(iii) It has been a period of mounting heterogeneity across sectors, subsectors and firms. Large national and foreign corporations are operating state-of-the-art plants, but modernity has been poorly and unevenly diffused through the economic system. The increase in productive heterogeneity is particularly striking in the labour market, where the share of total employment represented by low-productivity sectors is on the rise.

(iv) Underemployment and unemployment explain why, in spite of the increase in social expenditure, income distribution has remained rigid; any rise in productivity that occurs has been used primarily to boost profits and, in some cases, to cover the wages of highly-skilled labour, with very little trickling down to the masses of unskilled workers.

The above statements may be summed up as follows: the poor performance of the Latin American economies over the past 25 years was due largely to the implementation of the wrong reforms and policies –both with respect to resource allocation and to macroeconomic and financial matters– and to the lack of national development strategies. This performance resulted in inadequate diversification of production, structural heterogeneity, unemployment and underemployment, low wages, poverty and income concentration, and in the persistence of foreign exchange gaps, external vulnerability and per capita income disparity compared with the developed economies.

The work of Prebisch and Furtado can also serve as inspiration in analysing the future outlook for the region. For instance, it may be said that, as in other past downswings in the region throughout the 500 years of its economic history (when long periods of time passed before growth was reestablished), so far no new engine of growth has emerged. The key questions are: Is this going to be a protracted period of stagnation in which duality, heterogeneity, external balance-of-payments constraints and "divergence" will continue? What are the potential driving forces for investment, technological progress and productivity growth in Latin American economies today? Can some new model of growth be envisaged? What are the connections between possible strategies for achieving economic prosperity in the future and employment and income distribution?

V

Furtado, structuralism and neostructuralism

If it is granted that this list of statements is relevant to an understanding of trends in the past 25 years, then the relevance of the Prebisch-Furtado approach must also be conceded.

Many of the best heterodox interpretations of current trends in Latin America provide sound analyses of monetary and financial issues in line with ECLAC neostructuralism[8] and related schools of thought. These texts were a necessary advance with respect to the initial structuralist interpretations, especially in the present era of macroeconomic uncertainty, capital volatility and financial constraints.[9]

At the mesoeconomic and microeconomic levels, the analytical capacity of the neostructuralists of today does justice to the founders of this school of thought. Current publications clearly show the need to encourage infrastructure and technology-intensive investments, to build national innovation systems and promote education, and to foster sectoral complementarities, clusters and small and medium-sized enterprises.

Nevertheless, if the work of present day neostructuralists is compared with that of their precursors, the former provide an insufficient analysis of the determining factors of investment and growth models.

Capital accumulation was a structuralist and Furtadian obsession which, unfortunately, has now fallen into disuse. The neo-structuralist analysis of the issue is sound insofar as it relates the scarcity of investments to macroeconomic uncertainties, including capital volatility and exchange-rate and interest-rate instability and the contraction and fluctuation in levels of activity. But little has been said about the relationship between the propensity to invest and reforms (trade liberalization and privatization) or about the propensity to invest in general.

In one of the few studies on this issue, Moguillansky and Bielschowsky (2001) argue that opening up the economy causes domestic firms in tradable-goods sectors to experience a decline in profitability and a rise in levels of risk and uncertainty, which amounts to lower incentives for investment. Also, before privatization, when State-owned firms made investments, they were less concerned about profitability, as well as being less averse to risk and uncertainty. This suggests that privatizations reduce the propensity to invest in the economy, although they can perhaps increase the microeconomic efficiency of investments. There is, therefore, good reason to believe that the current low propensity to invest may have a great deal to do with the reforms and that the new context requires some sort of public-private coordination in order to boost investment.

Lastly, neo-structuralism owes much to original structuralism in terms of alternative growth models to

[8] This expression was coined after the ECLAC economists assimilated the irreversibility of the liberalizing reforms, whose flaws they criticized, and made recommendations for correcting the course. The pioneering document with respect to the neostructural phase –*Changing Production Patterns with Social Equity* (ECLAC, 1990)– was coordinated by Fernando Fajnzylber, who transmitted to ECLAC the thinking that had been developed in the previous years (see Fajnzylber, 1989).

[9] See, for example, ECLAC (1995 and 2002); Ffrench Davis (1999), and Ocampo, Bajraj and Martin (2001).

the neoliberal model which take into account the peculiar conditions of each Latin American country. Much would be gained from a return to the practice of formulating national development projects following Furtado's line of thinking, namely, that of growth patterns or models, which others –such as Anibal Pinto, Conceiçao Tavares and Jose Serra, and Pedro Sainz and Alfredo Calcagno–[10] sometimes called "models" or "styles" of growth.

From a historical and structuralist perspective, a pattern of growth is a historically-determined, country-specific combination of a number of structural elements which are responsible for the dynamic of growth, investment, productivity, employment and wages. The most important of these elements are: (i) the principal investment agents (the State, local and foreign capital); (ii) the financial equation for investment (retained profits versus domestic and foreign finance); (iii) the composition of production and of foreign trade, together with the associated technological choices; (iv) the direction of growth –inward, outward, or both; (v) trends in employment and underemployment; and (vi) trends in income and wealth distribution.

These factors, taken in conjunction with the macroeconomic regime and financial relationships with the rest of the world and institutions existing in each country, provide a good road map for an investigation into what is going on today in each Latin America country. On this basis, it may be possible to come up with a map of similarities and differences in the behaviour of individual countries that may help to design development projects for each nation and construct a broad and diversified strategic agenda for the region as a whole.

VI

Summary and conclusion

This brief article has presented Celso Furtado's three main analytical contributions to structuralism.

The first, which forms the basis of the historical-structural method, was the incorporation of Brazilian and Latin American history into structuralist formulations. The second was the belief that underdevelopment in the Latin American periphery tends to persist over long periods owing to two deeply entrenched conditions: underemployment and inadequate diversification of production. According to Furtado, underdevelopment is not simply a phase of transition towards development, but a more permanent phenomenon, which cannot be overcome without a tenacious and long-term political commitment.

The third contribution is based on the idea that investment patterns in the periphery are predetermined by the composition of demand, which reflects income and wealth concentration. In Latin America, supply structures, which are inappropriate for absorbing the abundant labour force, are being reproduced, keeping wages low and tending to reinforce the unequal pattern of income distribution.

In the light of developments in Latin America in the past 25 years, Furtado's analysis, unfortunately remains fully relevant. The two central elements of underdevelopment –namely, the insufficient diversity of the production base and the structural duality or heterogeneity– have not been overcome, and as a result, wages have remained low, and income concentration and poverty levels, high.

An agenda inspired by Celso Furtado for surveying current trends and future prospects for Latin America would undoubtedly provide a comprehensive and necessary analysis and would confirm the validity and relevance of his contributions.[11]

(Original: Portuguese)

[10] See Pinto (1976); Tavares and Serra (1972), and Sainz and Calcagno (1992).

[11] In the case of Brazil, Furtado's approach, far from being a mere research agenda, was adopted as a national development project within the 2004-2007 Multi-year Plan (Brazil, 2003). Although this plan was signed by the President of the Republic and adopted by Congress, unfortunately, it does not seem to have been adopted, disseminated and properly implemented by the Government. Nevertheless, it sets out an encouraging long-term development strategy, whose conceptual basis is precisely Furtado's work of the 1960s and 1970s, in which he calls for the formation of a virtuous circle of investment, wages and consumer rights.

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Has investor protection been rendered obsolete by the Argentine crisis?

Michael Mortimore and Leonardo Stanley

Unlike the train of events in previous crises, when the negotiations between the parties –creditors and debtors, investors and host countries– were played out within some kind of institutional framework, the crisis of 2001 portrayed Argentina as a country abandoned to its fate, not just once, but twice. But although investors had initially been able to alter the rules in their favour to secure better protection and enhanced legal certainty, ultimately they came out of the situation worse off. The Argentine experience suggests that, as the influence of the international financial institutions declines, asymmetric solutions cannot last and, at the end of the day, democratic governments will put their electorate before their investors. But is the Argentine case an exception to the rule or does it reflect a more general weakening of foreign investment protection?

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I
Introduction

Foreign investment has played a key role in the Argentine economy in the last 30 years, especially in the 1970s and the 1990s, when inflows reached highs of 8% of GDP (see figure 1). These highs were associated with three types of investor: first, in the 1970s, transnational banks that extended large syndicated loans; then, in the 1990s, with financial intermediaries who lent voluminous sums in bonds and TNCs that made heavy direct investments.

Notwithstanding this, on 23 December 2001 Argentina shook the international financial community by announcing a default of over US$ 100 billion on its public debt. The default involved more than 150 varieties of financial paper governed by eight different jurisdictions. The magnitude of the default was obvious: at the time, Argentina's debt represented a quarter of all debt traded in the emerging bonds market. At the same time, in January 2002, the Argentine peso declined to one third of its value and the Government "pesified" public utility rates. This infringed the contracts signed with TNCs operating in the country and prompted a number of international lawsuits against Argentina under the terms of bilateral investment agreements. The Argentine case formed a landmark in modern financial history, not only because of its sheer magnitude, but also because it combined two different crises and because of the institutional circumstances in which they unfolded. In fact, the extremity of the debt crisis was such that the balance tipped in the debtor's favour. The foreign direct investment (FDI) crisis, by contrast, had long-term repercussions associated with the pattern of investment in the sectors affected.

To start with, the Argentine case brought new twists into the dispute between sovereign debtors and creditors. Unlike what had occurred in the 1980s, Argentina had more bargaining power in this financial crisis, since at the time of the collapse its creditors consisted of a dispersed and unorganized mass of thousands of bondholders, rather than a small number of strategically grouped transnational banks. Argentina was not coerced into a renegotiation, therefore. This was in addition to the misguided strategy of the bondholders, who, anxious to limit their debtor's leverage, blocked all attempts at renegotiation. In the Argentine case at least, this strategy ultimately backfired. It was also clear that there was no institutional framework, since the International Monetary Fund (IMF) was unable to play a more significant role in the renegotiation. Lastly, divisions within the Group of Seven (G7) had a far from negligible influence on the course of events. In the light of these last two factors, Argentina could do no other than devise a solution of its own.

With regard to the real sector, i.e., FDI in utilities, the bilateral scheme for treatment of investment had existed since the late 1950s, but did not become widely used until the 1990s, which saw not only a large increase in FDI flows to developing countries, but also the establishment of international arbitration procedures. Argentina soon became one of the most fervent advocates of the bilateral scheme, signing more than 50 bilateral investment agreements and joining the World Bank's International Centre for Settlement of Investment Disputes (ICSID).

The guarantees Argentina extended in contracts with foreign direct investors, especially those with interests in utility companies, gave those investors a basis on which to sue the country after the declaration of the economic emergency law. This began a process that has cited Argentina in more than 40 lawsuits, which alone account for almost 40% of cases outstanding before ICSID, the main international institution for the settlement of investment disputes between foreign investors and host governments.

A number of authors have researched the causes of the recent crises, but there is no consensus on the trigger. Some blame the Argentine authorities for adopting policies that ultimately led the country into a crisis. Others suggest that creditors and investors were incautious in choosing a capital investment location. This paper seeks to spotlight a different aspect, however: the role of the international financial institutions (IFIs).

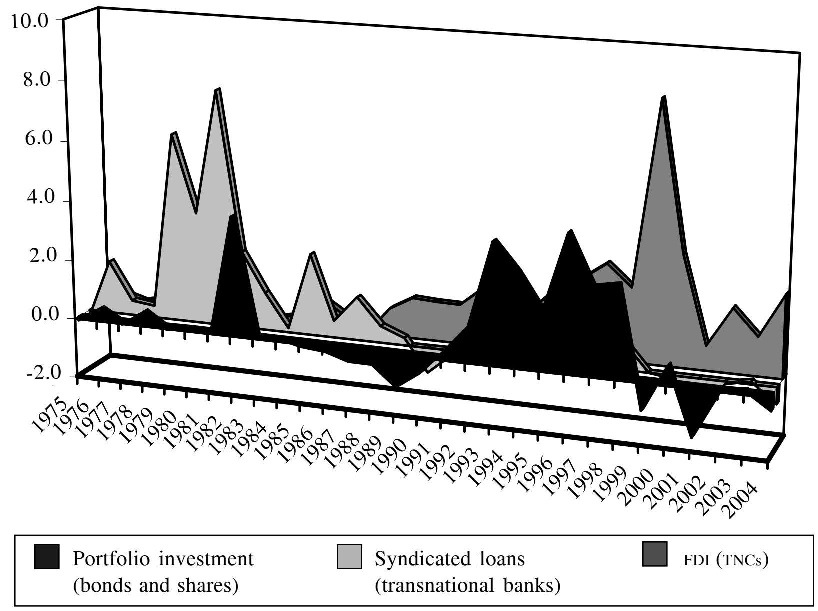
Despite strong growth of flows of capital and FDI in the 1990s, IFIs continued to be weak, irrelevant and inconsistent. This being so, when crises occurred, the

□ The authors are grateful for comments by a judge who preferred to remain anonymous. The opinions expressed in this paper are the sole responsibility of the authors and do not necessarily coincide with those of the organizations to which they belong.

FIGURE 1

Argentina: foreign investment cycles, 1975-2004

(Percentages of GDP*)*



Source: Authors' calculations on the basis of World Bank data (2004).

market option (financial system) or the bilateral investment scheme tended to prevail, even though neither offered lasting solutions.

The rest of this work addresses these two aspects, looking at the way financial standards and rules on the treatment of FDI have evolved. Argentina's problems are examined in the light of each of the conflicts the country experienced when the Government dismantled the convertibility scheme (fixed exchange-rate regime) and, lastly, a number of considerations are set forth concerning the implications for foreign investor protection.

II

The financial crisis

1. Absence of the international financial system

In the 1970s, cracks began to appear in the financial scheme that had emerged after the Bretton Woods Conference (1944). Overflowing with liquidity thanks to large, readily available deposits (eurodollars) and strongly rising petroleum prices (petrodollars), the transnational banks set out to find new clients, mainly in newly independent and Latin American countries. In Latin America, the wide availability of funds fuelled a new model of growth. But despite the precautions of investors[1] and the benefits the new model brought for borrowers, the stage was set for a serious crisis, which broke out in 1982.

After Argentina formally defaulted, there ensued a wide-ranging debate on the framework of the renegotiation. Divisions emerged between the proponents of an institutional scheme and those in favour of letting the market resolve the crisis (Eichengreen, 1988). Thus, the crisis evolved in three stages. First, the transnational banks attempted to lever all the costs onto the debtor countries in the form of

[1] Contracts for loans extended from the United Kingdom and the United States imposed a sovereignty waiver in the event of a dispute, among other clauses. The creditors believed that this strategy would make a default impossible.

restructuring loans, which entailed extremely high commissions and interest and stringent economic conditionalities imposed by IMF. Second, IFIs set forth a restructuring programme aimed at helping the debtor countries to deal with the debt burden, requiring the transnational banks to lend more. Following the banks' refusal, there was a third stage in which the United States Treasury Department provided more active support through mechanisms to reduce the value of the debt (Brady bonds, debt-for-capital swaps, and so forth). Thus, separately from the debate, the debt restructuring process developed into essentially a private matter with an asymmetric outome in which the debtors shouldered the heavier share of the adjustment burden. This lasted until it became clear that the crisis would not be worked out unless the debt was reduced and some of the adjustment costs shifted to the main creditors. Unfortunately, it took about 10 years for this conclusion to be reached (Mortimore, 1989; UNCTC, 1990; ECLAC, 1989).

By the early 1990s the situation had changed again. With the end of the crisis, capital returned to the Latin American countries and the nature of financing changed, as bonds replaced loans. With the outbreak in 1994 of the tequila crisis (triggered in Mexico) the possible mechanics of an institutional framework for such situations again became a discussion point. At that point, a wide range of options were proposed; some favoured the introduction of collective action clauses and others the institutionalization of some kind of scheme of economic and financial reorganization, principally along the lines of United States bankruptcy proceedings.

Those in favour of the institutional approach included Jeffrey Sachs,[2] who proposed a bankruptcy regime of international scope based on chapter 11 of the United States bankruptcy law. The idea was to set up a legal framework which would give governments temporary support to renegotiate with their creditors before the respective lawsuits were brought.

Advocates of the market stance argued in favour of the conflict being worked out between the contracting parties (the sovereign debtor and the creditors), without the intervention of third parties (an arbiter such as IMF or another international agency). But, admitting the impossibility of arriving at an agreement that would satisfy all of the bondholders, many academics and policymakers[3] began to consider it advisable to devise some kind of clause that would enable the majority group of bondholders to renegotiate with the sovereign debtor.[4] This was resolved with the introduction of a collective action clause, which reduced the power of creditors, known as holdouts, who opted not to participate in the renegotiation.

However, the toughest creditors deemed this alternative non-viable, on the grounds that any kind of clause that broke the unanimity conditions would represent an erosion of their rights.

This was the point the debate had reached when it was interrupted by two developments in 2001. First, was the entry to office of the Government of George W. Bush,[5] which was to play a strong role in the later debate, in the United States. Second, the situation in Argentina continued to worsen, and default began to appear inevitable.

These developments led the new Chief Economist of IMF, Anne Krueger, to propose the Sovereign Debt Restructuring Mechanism (SDRM). This mechanism was based on United States bankruptcy law and included elements of two chapters of this legislation: chapter 11 on corporations and chapter 9 on municipalities. The most salient aspects of the proposal referred to increased Fund involvement in bankruptcy administration and the establishment of a new institution, the Sovereign Debt Dispute Resolution Forum (SDDRF), to oversee the process of sovereign bankruptcy.

Not surprisingly, this scheme met with the disapprobation of the financial community, which felt that crises should be worked out by the market and that debtors' leverage should be kept to a minimum. This was the position adopted by the Institute of International Finance (IIF, 1999; 2001), which viewed even temporary attempts to defer debt payment or any other avenue leading to arrears as illegitimate.

At the same time, the United States Secretary of the Treasury was insisting on letting the market have a stronger influence and, paradoxical though it may seem, suggested that at some point investors would have to

[2] See Sachs (1995).

[3] The proposal was backed at the academic level by Eichengreen, Portes and others (1995) and at the government level by a report of the Group of Ten (G-10) (1996).

[4] As occurs in the case of bonds issued under the jurisdiction of London.

[5] The presidential changeover also implied the replacement of Larry Summers and Stanley Fischer, of the United States Treasury Department and IMF, respectively, by R. Taylor and Anne Krueger.

assume their part in the settlement of the dispute.[6] This new stance brought into play five new principles that were supposed to steer the resolution of the crisis (Machinea, 2002, pp. 31-32): (i) that this resolution would not imply a write-down in the liabilities of debtor countries; (ii) that creditors would not believe that official assistance would protect them from moral hazard; (iii) that private sector engagement could help to reduce the public sector's borrowing needs; (iv) that, as far as possible, private sector involvement should take the form of voluntary schemes agreed upon between debtors and creditors; and (v) that no category of private debt should be afforded special treatment. These guidelines would be applied on a case-by-case basis and IMF would work out the details.

Thus the debate ended up leaning more towards a market solution, pushing the relevant international agency, IMF, into a less influential role. Argentina was lined up to be the first country to deal with its debt crisis under this new approach. However, given the failure to define a renegotiation scheme and the lack of leading role for the Fund, Argentina ultimately crafted its own solution for the debt swap.

2. Convertibility in Argentina: origins and crisis

The launch of the convertibility plan in March 1991, under the Convertibility Law, enabled Menem's Government to stabilize the economy after the chaos that followed the debt crisis of the 1980s, with the introduction of a fixed one-to-one dollar-peso exchange rate. Although this was costly in economic policy terms, it soon gained broad acceptance. The fact that the convertibility regime effectively tied the hands of policymakers in fiscal and monetary matters enhanced Argentina's credibility vis-à-vis external creditors and multilateral institutions.

More or less simultaneously, Argentina moved ahead with an ambitious programme of privatizations and launched a process of financial and trade deregulation and liberalization. The privatizations soon became one of the pillars of the new economic programme. From an aggregate point of view, the sale of public assets and the use of the debt-capitalization scheme (UNCTC, 1990, p. 85) enabled Argentina to attract fresh FDI, reduce its external debt and remove the financial liabilities generated by public utilities from the public sphere. From a microeconomic perspective, the process was soon to draw criticism for focusing on a quest for credibility (Gerchunoff and Canovas, 1995), which would ultimately tie the fate of the privatized firms to the success of the convertibility plan.

As far as macroeconomic performance goes, the effects of the plan kicked in quite quickly and hyperinflation and instability became things of the past. Inflation dropped impressively and the economy, fuelled by domestic demand, expanded steadily thanks to the increase in real wages and the reappearance of credit, although this generated a trade deficit. But investment was rising too. Thus the country entered a solid upward spiral of growth, with the economy expanding by around 9% per year in 1994, and productivity increased (Stallings and Peres, 2000, p. 78). At the same time, public external debt was trending downwards thanks to Brady bonds.

Argentina thus became catalogued as a fast-track reformer, winning the support and approbation of the international financial community and of the Washington-based international financial institutions (IMF, World Bank and IDB).

The economy continued on an upward course until the tequila crisis; but this challenge, too, was quickly overcome and confidence in the model restored. The situation began to change in the second half of the 1990s, however, when a series of financial crises broke out, starting in East Asia. In 1998, the Argentine economy slipped into a downward spiral towards depression and crisis.[7]

3. Declaration of default and renegotiation of the public debt

Thirty-eight months after the declaration of default, and with no help whatsoever from IMF, Argentina shed its defaulted status when its offer was widely accepted (by over 75%) among bondholders and it achieved what no country had achieved before: the bondholders not only accepted a large cut in principal, but agreed to a lengthening of maturity and a reduction in the interest rates finally paid. In other restructurings, creditors have had to accept one of these measures, but Argentina achieved all three (*The Economist*, 2005).

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[6] It was thought that this stance would reduce the problem of moral hazard, by avoiding international agency resources being used to lower the risks of private investment in emerging markets.

[7] The many causes cited to explain the failure of the convertibility scheme fall into three main categories: structural reasons, based on the overvaluation of the exchange rate; fiscal reasons that cite lack of fiscal discipline on the part of the Government; and behavioural reasons that point to the role of unrealistic expectations in triggering the crisis.

What were the factors that enabled Argentina to impose a unilateral solution in the process of debt renegotiation?

To start with, any solution was going to depend on the Government's swap proposal, the leverage of each of the parties and the stances taken by the international financial institutions and the developed countries in the renegotiations.

The Government's proposal was both unilateral and ambitious. Argentina's "game plan" could be defined as non-cooperation ("take it or leave it"), working on the supposition that the creditors' bargaining power would weaken over time. The short-term cost to the country was minimal, since Argentina clearly had no possibility of obtaining external financing in the international financial markets anyway. The additional resources the Government could access by not paying its external debt, together with the introduction of new taxes (withholding tax on exports), the higher level of economic activity and, probably, improved tax management, enabled the new leader, President Kirchner, to adopt a tougher negotiating stance with creditors.

The offer was all the more unilateral given the Administration's patent lack of interest in finding an interlocutor.[8] The Government's every move was aimed at preventing the creditors from coordinating with each other. This implied a course from which there could be no turning back: from then on, the question was the level of acceptance the swap could achieve. A high acceptance level would ensure the operation's success, although the move was risky in that a failure would reunify the bloc of creditors and align them behind the demand for a new swap proposal. In weighing up the strategy's probabilities of success, however, the Government already had a significant "floor acceptance", since around 30% of the debt stock was held by local financial agents (retirement and pension funds administrators, insurance companies, institutional funds, financial entities and so on) whose acceptance could be taken for granted. Ultimately, the lack of cohesion among the different organizations representing the creditors worked to the advantage of the Government.

The unilateral offer, however was indirectly supported by the other actors. On the one hand, the international financial institutions had no hand whatsoever in the launch of the swap, which was attributable to the dissension on how to deal with such situations.[9] On the other, the developed countries did not adopt a unified stance, and the Government of President Bush has taken a *laissez-faire* approach to sovereign crisis resolution (Roubini, 2005). The non-intervention of IMF together with the lack of cohesion within the G7 ultimately benefited the debtor country.

There are also a series of exogenous factors that ought not to be disregarded. The international economic situation, associated with low interest rates in the United States, and the narrowing of emerging bond spreads, improved the conditions of the offer[10] at no cost to Argentina. It should also be considered that the Government's proposal was not far off the bonds' market value at the time the swap was launched (Roubini, 2005).

The outcome of the swap far exceeded Argentina's expectations. The fact that Argentina worked out its default unilaterally without the intervention of the international financial institutions has sent strong signals to the financial markets. Given the inoperativeness of these institutions and the existence of (numerous) creditors and investors keen to teach Argentina a lesson,[11] is the situation salvageable or will more sovereign debtors follow Argentina's "example"?

[8] This strategy was later reinforced by the Minister of Economic Affairs, with the establishment of the floor level of acceptances to consider the swap a success (50%); the adoption of legislation preventing the Government from reopening the swap without the approval of the National Congress, and the stance of not permitting the involvement of IMF in negotiations with creditors.

[9] In addition to this dissension was the fact that IMF would have had little credibility (mainly vis-à-vis the Argentine Government) to mediate among the parties (IMF, 2004).

[10] By reducing the discount rate used to calculate the offer's present value.

[11] The success of the unilateral debt swap does not detract from the fact that Argentina will face serious problems if it attempts to return to the international financial markets. In addition, the discounted external private debt still represents a heavy financial burden that the country will have to begin to pay in the future. As Argentina is forced to seek external financing, its current bargaining power will be weakened.

III

The other crisis: FDI in public utilities

1. Rules or discretionary powers in the international system

Since the mid-twentieth century, bilateralism has been growing in strength as it became increasingly difficult to arrive at a multilateral consensus on the degree of protection that ought to be afforded to FDI. After the end of the Second World War, the United Nations Conference on Trade and Employment (1948) was held with a view to setting up an "international trade organization" (ITO), which would deal with all matters of trade and investment. The Conference arrived at an agreement only on trade matters, however, and this was set out in the General Agreement on Tariffs and Trade (GATT). The issue of investment attracted scant interest until the start of the Uruguay Round (1982), when the countries began to debate the process of strengthening foreign investment. This led to a series of partial multilateral agreements on trade-related investment measures (TRIMs), trade in services (GATS), a special energy agreement known as the Energy Chapter[12] and trade-related aspects of intellectual property rights (TRIPs). Any attempt to introduce some sort of agreement on investment was doomed to failure, however, as evidenced by the multilateral agreement on investment (MAI) initiative launched by OECD and later attempts in the framework of WTO (the Singapore Declaration and the Doha Ministerial Declaration).

The process of economic and political transformation that began in the 1980s and deepened in the 1990s thus led to the signature of numerous bilateral investment agreements, and use of the bilateral scheme became widespread.

The success of the bilateral scheme does not refute the proposal of Kydland and Prescott (1977) on the advisability of establishing rules of economic policy, instead of leaving it to be handled on a discretionary basis. This is particularly relevant in the case of investment because, unlike trade flows, investments have important consequences for the future, which makes them more vulnerable to opportunistic moves on the part of governments.[13] This point is even more important when inbound FDI is going to public utilities, in which the intertemporal natural of the problem is made more acute by the State's role in regulating rates, investments and service quality. In this case, discretionary administrative jurisdiction or governmental opportunism can be serious matters and the lack of contractual commitments can prompt firms to reduce or even, in the most extreme cases, suspend their investments. To avoid this kind of situation, the Argentine Government established rules and guarantees as a way of limiting its own manoeuvring room to alter contracts.[14]

Rules on investors' rights were adopted implicitly by signing bilateral investment agreements and through membership of international institutions whose purpose it is to settle disputes between investor and State (ICSID or similar bodies). The bilateral scheme gathered tremendous momentum, and the number of bilateral agreements jumped from less than 400 in 1989 to 2,392 in 2004, of which 70% were operational (UNCTAD, 2005a). As for ICSID, from having five outstanding cases representing US$ 15 million a decade ago, the Centre now has 113 cases worth US$ 30 billion (Dañino, 2005).

Certain rules did become harmonized in the framework of the bilateral scheme as it gathered strength, but it had a number of disadvantages with respect to the multilateral system. Without a doubt, the benefits of such schemes leaned heavily towards the investors, who used them to secure important guarantees. For capital-exporting countries, the bilateral scheme facilitated and protected outward investments by native firms and became a channel for introducing greater demands (Moltke and Mann, 2004).

The bilateral scheme had its advantages for FDI host countries, since the start-up of such regimes sent a positive signal to foreign investors. Its effectiveness, however, was subsequently to be called into question.

[12] A multilateral agreement devised to encourage private-sector engagement in the energy sector in the former Soviet republics.

[13] Opportunism arises because of the intertemporal nature of the relationship, since the government may be tempted to change the rules set at the start.

[14] The more comprehensive the contract extended, the greater the Government's commitment to non-renegotiation.

An econometric study (UNCTAD, 1998) found that no causal relationship existed between FDI flows and the signature of bilateral investment agreements.[15] Hallward-Driemeier (2003) found that the examination of FDI flows from developed countries did not sustain the conclusion that higher protection acted as a pull factor for additional investment. This author found that the choice of investment location continued to be driven by factors such as market size, strategic reasons or natural resource endowments. With respect to United States investments, Sullivan (2003) concludes that the bilateral protection agreement framework has little bearing on investment location decisions.[16] Tobin and Rose-Ackerman (2003) examined the contribution of bilateral investment agreements to well-being and concluded that the effect was at best ambiguous, since such agreements could not only be harmful in terms of flexibility but could also end up benefiting the foreign investors over the population at large. Ultimately, the studies cited call into question the hypothesis that increased protection always brings greater inflows of FDI and signal that, conversely, they impose very significant international commitments on the recipient countries.

The advantages for host countries wane even more in view of the pro-investor bias that this type of scheme tends to build up in terms of investors' rights and guarantees against expropriation, especially of the "indirect" variety. This trend is evident in new bilateral investment agreements which are ever broader in scope and impose increasingly large constraints on government action. Foreign investors also have an advantage when it comes to assessing whether a particular government measure may be considered expropriatory, leading firms to "defy" attempts to alter existing laws and regulations (Stanley, 2004). This phenomenon is beginning to be examined after widespread complaints in the framework of NAFTA[17] and is now spreading into other jurisdictions (Moltke and Mann, 2004; Peterson, 2004).[18]

These considerations lead to the conclusion that the bilateral investment agreement scheme can be detrimental in certain circumstances. Investor's rights have gained so much ground that they risk causing disproportionate costs in the recipient countries.

2. The Argentine crisis and FDI

The abrupt end of exchange rate parity opened a new front in the dispute with foreign investors, now with those who had invested in the real sector, especially public utilities. Under the agreements signed in the 1990s, investors felt that they were entitled to full compensation from the Government. Although most investors in Argentina were affected by the change in the exchange rate model, the bulk of the complaints came from those with some kind of interest in public utilities, mainly those associated with the energy industry (gas and electric power).[19]

The predominance of this type of investment was due not only to the guarantees offered under the new bilateral scheme (such as the mechanism for settling disputes between the State and the investor), but also the provision of national regulations (for example, rates set in dollars and indexed to the United States wholesale price index). The contractual framework consisted of legislative provisions, regulatory terms and agreements reached with third countries through bilateral investment schemes guaranteed in an independent international legal framework (ICSID or other arbitration tribunal). Thus, seeking to ensure the arrival of investors and the success of the scheme, the Government ended up by accepting a system of "complete" contracts, thereby accepting risks that did not correspond to it.

This mechanism helped the Argentine Government to demonstrate its commitment to international standards, but it also became the main shield behind which foreign investors started legal proceedings. The

[15] According to UNCTAD, agreements play a minor role in defining the destination of FDI flows, although this role may be more important in certain circumstances.

[16] Eighty percent of United States FDI goes to three countries (Mexico, China and Brazil) with which the United States has not signed any special investment protection agreement, except in the context of NAFTA, which Mexico also signed.

[17] The health and environment sectors are among the worst affected, because of firms pressuring the State not to alter the original rules. The threat of legal action imposes a constraint known as regulatory chill on the capacity to regulate. This was among the phenomena that gave rise to a debate on Chapter XI of NAFTA.

[18] Basically because of the new bilateral investment agreements launched by the United States. The papers cited discuss the cases of South Africa and Malaysia, whose respective Governments have encountered strong resistance –on the part of foreign investors– to the introduction of programmes aimed at racial or ethnic equality.

[19] According to the International Institute for Sustainable Development (IISD), bondholders not included in the Argentine Government's debt swap and organized by the Global Committee of Argentine Bondholders planned to bring the Government of Argentina to arbitration proceedings based on investment agreements (IIDS, 2005).

spirit of the restrictions the Government had imposed upon itself (the legislation combined with the agreements) was to minimize the possibility of contract renegotiation with privatized firms, since the magnitude of the commitments made any alteration, however necessary, too costly. Ultimately, the crisis was to demonstrate the intrinsic "incompleteness" of the contract scheme implicit in the regulation of the privatized firms (Guash, Laffont and Straub, 2002; Navajas, 2004). As successive Administrations proved reluctant to abide by the terms of the contracts signed, a number of investors began to withdraw –this may have been the case of the French firms EdF and France Telecom and National Grid of the United Kindgom– and investments were confined to those needed to maintain quality of service.

This divergence prompted a torrent of suits before ICSID. Argentina is currently facing 42 lawsuits,[20] including four brought before the United Nations Centre for International Trade Law (UNCITRAL),[21] which raise the country's contingent liabilities by around US$ 20 billion. This amount could rise considerably if a series of potential suits before ICSID prosper.[22]

The measures adopted by the Government affected the economic and financial equation for investors. In the case of the regulated sectors (with pesified rates), the higher the level of indebtedness in dollars, the larger the impact of the measures. Hence, regardless of the sector, most of the disputes brought after 2002 cited the effects of the devaluation on contracts in general and on the rate-setting system in particular. Investors maintained that the Government of Argentina had agreed to assume the exchange-rate risk then broke this promise in January 2002.

Some of the most vigourous presentations came from regulated firms belonging to the energy sector (gas and electric power), which initiated 22 lawsuits (19 before ICSID and three before UNCITRAL). Given the strong vertical and horizontal that exists in those industries, the firms' complaints referred not only to the effects of the economic emergency law on rates, through pesification and rate freezes, but also to the effects on prices in the unregulated sector (in the case of gas, the price of inputs; in the case of electricity, the price of generation). Another group of plaintiffs in the regulated sector consisted of mainly French (five of a total of eight suits) investors with interests in the provision of drinking water and sanitation. A third group of cases were initiated by investors with telecoms operations (Telefónica S.A. of Spain and France Telecom S.A.). Yet another group of complaints were lodged by foreign investors who had some kind of contract with the public administration, who sued the State for breach of contract.[23] And one last of group of six suits involved firms that had no link whatsoever with the Government, who sued the country over the impact of the devaluation on their liabilities.

Although most of the cases cited more than one cause, pesification was the primary motivation for the lawsuits brought against Argentina (Stanley, 2004). Whatever the reasons signalled, however, the filing of cases was generally a strategic move in the positioning for renegotiation. Hence, after the economic emergency legislation was passed and the lawsuits filed, there ensued a wrangle between the Argentine Government, the foreign investors (mainly those with interests in the private sectors) and the international financial institutions (World Bank and IMF).

The Argentine response may be succinctly described as a sort of impeachment of the entire global system. Through the procurator of the treasury, the Government began by challenging the tribunal, questioning its transparency, the process by which the arbitration panel was selected and the fact that the investors were allowed to engage in forum shopping, i.e. select the tribunal most likely to provide a favourable judgment. By the same token, Argentina rejected the intervention of ICSID (by not recognizing its jurisdiction), claiming that cases should be heard, at least, in the local courts first. Lastly, in mounting a defence –the defence actually formulated in the case of CMS Gas Transmission Company and the denial of jurisdiction in others– the Government's strategy was to deny that the steps it had taken after declaring the economic emergency, i.e., pesification and rate freezes, amounted to expropriation.[24] Since all the suits cited a

[20] It should be mentioned that five of these were filed while the convertibility regime was still in place.

[21] See UNCTAD (2005b).

[22] See *El cronista comercial* (2005).

[23] These may be described as eminently defensive, since they arose as a consequence of a contractual breach, but with contracts that were strongly questioned (three cases). At the threat of becoming tied up in a legal battle with the Government, the investor brings a case before ICSID or some other arbitration tribunal with the aim of negotiating with the host country to drop the original suit.

[24] See the list of cases against Argentina brought before ICSID in annex.

single cause, the effect of the economic emergency legislation was central to the Government's strategy. The Government argued that the measures it had taken represented the only avenue open to it and the investors had to bear part of the adjustment burden. In Argentina's favour, it must be said that voices have recently been raised in a number of academic and political circles, expressing exactly the same reservations about the arbitration scheme.[25] On the other hand, the delay in renegotiating contracts with privatized companies worked against Argentina, by annoying those investors willing to cede part or all of their claims.[26] This is likely to keep inflows of FDI below their potential level for a long time.

With its proposals rejected and its arguments disallowed, the Government shifted its stance. One of its lines of approach was to seek to have the privatized firms withdraw their suits as a goodwill gesture in view of the contract renegotiation. With this in mind, the Argentine Administration lobbied the Governments of Spain and France, requesting them to intercede with their investors, thereby politicizing the lawsuits. Another, in view of the arbitration tribunal's award in the CMS case, was the Government's suggestion that it might disacknowledge any possible awards.

The responses from investors varied, depending on the strategic interest that each had at the point of filing the original claim. One group, consisting mainly of investors who still had strategic interests in the country, began to weigh up the benefits of withdrawing their suits.[27] Those firms that had withdrawn from the country (investors in public utilities) and those who had sued as a defensive response, i.e., investors who claimed breach of contract, appeared likely to continue with their legal proceedings.

The international financial institutions were fairly unresponsive to Argentina's arguments. Immediately after the crisis, the World Bank attempted to make a loan conditional upon renegotiation of the rates set in public utility contracts. The slow reaction of ICSID and its lack of definition of whether the Governments' measures were expropriatory or not created uncertainty, at least during the period when FMI was attempting to pressure Argentina. In response to this pressure, the Argentine Government prepaid all its outstanding Fund loans early (US$ 9 billion).

Regardless of the stances and strategies of the players, the Argentine case revealed the inadequacy of the scheme that exists under the auspices of the World Bank for settling disputes between investors and host countries. With Argentina accounting for over 40% of cases pending resolution before ICSID, the problem has shifted to the door of the arbitration scheme, not the sued country. Legally speaking, the case showed up the inappropriateness of a system that prevents collective action even though most of the suits against Argentina cite the same cause (contract breaches following the collapse of the convertibility scheme). This means that Argentina could find itself the subject of 40 different and possibly contradictory rulings (Goldhaber, 2004).

[25] See IISD/WWF (2001), Mann and von Moltke (2002), Peterson (2003) and OECD (2005a).

[26] This point was also mentioned in the award handed down in the CMS case (ICSID, 2005).

[27] The suits dropped include, reportedly, those filed by: Empresa Distribuidora y Comercializadora Sur S.A. (EDESUR), AES Corporation, Pioneer National Resources Co., Camuzzi, Gas Natural BAN, Empresa Distribuidora y Comercializadora Norte S.A. (EDENOR) and Unysis, which would lower the total amount claimed by over US$ 4 billion (*El cronista comercial*, 2006).

IV
Conclusions

The vagaries of the relationship between foreign investors and host countries have sometimes favoured the former, with examples being international rules that increase guarantees and legal certainty and the MAI initiative launched in the framework of OECD, and sometimes the latter, exemplified by inaction in response to the wave of nationalizations in the 1970s and the subsequent attempt to establish a code of conduct for TNCs in the framework of the United Nations. In the 1990s, the balance tipped excessively towards foreign investors.

Before the Argentine crisis, foreign investors had managed to enhance the guarantees and legal certainty that developing countries and transition economies provided, by introducing into their contracts with debtors a series of clauses waiving sovereign immunity in the case of default (as the transnational banks had done in the 1970s under the syndicated loan system). Foreign investors' guarantees and advantages were then further expanded as the bilateral scheme became more widespread and a dispute settlement mechanism was introduced enabling them to sue the host country directly.

When the Argentine crisis broke out, however, the international system failed to provide a solution to either the sovereign default or the losses of foreign investors caused by the country's refusal to apply the rates stipulated in the original contract. The bondholders were horrified to find that IMF was unable to force the Argentine Government to renegotiate its debt under any kind of preexisting scheme or provide assistance to bondholders who opted not to accept the swap offer –holdouts– in the hope of a better proposal from the Government of Argentina. Foreign investors were equally shocked to find that the World Bank was unable to oblige the Argentine authorities to abide by the original terms of utility contracts. For its part, the Argentine Government, in its dual capacity as debtor and host country, was also appalled by the functioning of the international system, because of the way it explicitly favoured foreign investors, the lack of objectivity of the international financial institutions (basically IMF) and attempts to condition the country's economic policy to fulfilment of international commitments. As a result, and in view of the social dimension of the crisis,[28] the Government found itself forced to choose between using resources to alleviate the social suffering caused by the crisis and allocating them to its international obligations to foreign investors. Ultimately, the international financial system failed to provide the Government of Argentina with specific solutions to resolve the multiple crises the country was facing.

The foregoing leads to consideration of the main lessons of Argentine case with respect to the existing institutional system. First, the solutions proposed are highly asymmetric, since they are heavily biased towards one of the parties –investor or host country– and lack long-term viability. Foreign investor's interest in securing guarantees through some type of market solutions or through bilateral investment agreements (or, more recently, through investment chapters in free trade agreements) does not seem, given its strong bias, an adequate solution to the problems associated with severe crisis. The new approach adopted by the United States Administration and IMF to dealing with financial crisis failed to offer a solution or protection to investors and paves the way for unilateral initiatives like that piloted by Argentina.

With respect to the treatment of investment, thus far all attempts to establish a multilateral scheme have failed to prosper because of differences of opinion within the bloc of investing countries. The notions underpinning those attempts are, in any case, no longer really relevant today if the idea is to solve the world's real problems. It is time to rethink the relationship between foreign investors and host countries, in order to arrive at an equitable and lasting multilateral scheme. With a view to this, an interesting starting point could be the recent initiative of OECD (OECD, 2005b) which rejects the previous approach (MAI) as intrusive and authoritarian towards developing countries.

Second, the recent Argentine experience suggests that, in the event of a multiple crisis, democratic governments will put the needs of their electorate before the demands of foreign investors. To suppose that

[28] Between 1999 and 2003 the proportion of Argentines living below the poverty line doubled, from 27.1 to 54.7% pf the population.

strengthening the bilateral scheme will afford foreign investors more continuous guarantees and legal protection is to forget that multilateral negotiations are the only framework available to developing countries and transition economies in which to bargain. Although thus far no multilateral agreement has been reached for the settlement of financial crises or investment disputes, the multilateral principle remains the best option for developing countries, because of the benefits in terms of equity, and for external investors, because it is more predictable. In the long term, it may also mean greater credibility.

Lastly, it may be asked whether in the Argentine case the protection extended to foreign investors ultimately worked against them, by forcing them to accept the conditions offered by the Government of Argentina. Even if this was not the case, it may become so in the medium term.[29] Questions are increasingly being raised over the bias that international financial institutions show towards foreign investors without providing concrete solutions to developing countries in the event of financial crisis or investment disputes, the latter of which are becoming more and more common. Disenchantment with these institutions is one of the many manifestations of mounting doubt with regard to the market-based adjustment models implemented in Latin America in the 1990s, which were excessively market-biased and limited in their benefits.

(Original: Spanish)

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[29] Strictly speaking, a repeat of the Argentine situation is unlikely, not because of the country’s debt-swap strategy or its stance in the renegotiation with investors, but because of the origin of all these events – the excessive guarantees extended by the Government in the 1990s.

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ANNEX

Legal proceedings brought before ICSID against Argentina

Order	Case Nº	Claimants	Sector or industry	Stakeholder firms	Bilateral investment agreement signed with	Main complaints
1	ARB/97/3	Compañía de Aguas del Aconquija S.A. and Vivendi Universal	Water and sewer services concession	Aguas del Aconquija	France	Breach of contract
2	ARB/01/3	Enron Corporation and Ponderosa Assets, L.P	Natural gas transport	TGS	United States	Application of stamp tax by provinces
3	ARB/01/8	CMS Gas Transmission Company	Natural gas transport	TGN	United States	Suspension of adjustment clause agreed upon. The suit was later broadened.
4	ARB/01/12	Azurix Corp	Water and sewer services concession	Azurix - Buenos Aires	United States	Breach of contract
5	ARB/02/1	LG&E Energy Corp., LG&E Capital Corp. and LG&E International Inc.	Gas distribution	Distribuidora de Gas del Centro; Gas Natural BAN and Distribuidora de Gas Cuyana	United States	Suspension of adjustment clause agreed upon. The suit was later broadened.
6	ARB/02/8	Siemens A.G.	Informatic services contract with the public sector	Siemens Argentina	Germany	Non-fulfilment of contractual obligations
7	ARB/02/16	Sempra Energy International	Gas distribution	Share in Camuzzi Gas del Sur SA (through SODIGAS Sur) and Camuzzi Gas Pampeana SA (through Sodigas Pampeana SA)	United States	Suspension of adjustment clause agreed upon; prevention from calculating rate in dollars and from sending remittances abroad
8	ARB/03/2	Camuzzi International S.A.	Gas distribution	Majority shareholder in Camuzzi Gas del Sur SA and Camuzzi Pampeana SA	Belgium-Luxemburg	Suspension of adjustment clause agreed upon; prevention from calculating rate in dollars and from sending remittances abroad
9	ARB/02/17	AES Corporation	Electricity generation and distribution	Generation (AES Paraná SA; CT San Nicolas SA; CH Alicurá SA; CH Río Juramento; CH Dique; CHT San Juan SA; Termoandes SA; AES Caracoles SA) Distributors (EDES; EDEN; and EDELAP)	United States	Suspension of adjustment clause agreed upon; prevention from calculating rate in dollars and from sending remittances abroad
10	ARB/03/5	Metalpar S.A. and Buen Aire S.A.	Automobiles and autoparts	Manufacture, sale and finance of autoparts for public transport (bodywork)	Chile	Effects on private contracts of termination of convertibility
11	ARB/03/7	Camuzzi International S.A.	Electricity distribution and transport	Control (indirect) over EdERSA (Río Negro); EDEA (Buenos Aires); and Transpa (Transportadora de Electricidad en la Patagonia Sur)	Belgium-Luxemburg	Suspension of adjustment clause agreed upon; prevention from calculating rate in dollars and prevention from sending remittances abroad

Annex (continued)

Order	Case Nº	Claimants	Sector or industry	Stakeholder firms	Bilateral investment agreement signed with	Main complaints
12	ARB/03/9	Continental Casualty Company	Insurance company	Control (indirect) over CNA Aseguradora de Riesgos de Trabajo	United States	Loss of investment value due to effects of economic emergency law. Prevention from sending remittances abroad.
13	ARB/03/10	Gas Natural SDG, S.A.	Gas distribution	Majority shareholder in Gas Natural BAN	Spain	Suspension of adjustment clause agreed upon; prevention from calculating rate in dollars and from sending remittances abroad
14	ARB/03/12	Pioneer Natural Resources Company, Pioneer Natural Resources (Argentina) S.A. and Pioneer Natural Resources (Tierra del Fuego) S.A.	Petroleum concessions	Pioneer Natural Resources Argentina SA and Pionner Natural Resources Tierra del Fuego SA	United States	Pesification of deposits; application of exchange controls and prevention from transferring remittances; application of restrictions on crude exports; application of stamp tax by provinces; and prevention from deducting certain taxes
15	ARB/03/13	Pan American Energy LLC and BP Argentina Exploration Company	Petroleum concessions	PA Continental SRL; PA Sur SRL; PA Fueguina; Argentine. Share in Central Dock Sud SA	United States	Pesification of deposits; application of exchange controls and prevention from transferring remittances; application of restrictions on crude exports; application of stamp tax by provinces; and prevention from deducting certain taxes
16	ARB/03/15	El Paso Energy International Company	Petroleum concessions	Share in Compañías Asociadas Petroleras SA; CAPEX SA; Central Costanera SA and Gasoducto del Pacífico SA. Control (indirect) over El Paso SRL	United States	Pesification of deposits; application of exchange controls and prevention from transferring remittances; application of restrictions on crude exports; application of stamp tax by provinces; and prevention from deducting certain taxes
17	ARB/03/17	Aguas Provinciales de Santa Fe, S.A., Suez, Sociedad General de Aguas de Barcelona, S.A. and Interagua Servicios Integrales de Agua, S.A.	Water services concession	Aguas de Santa Fe	France	Prevention from applying agreed mechanism of rate calculation (pesification of rates and suspension of adjustment clauses based on international parameters)
18	ARB/03/18	Aguas Cordobesas, S.A., Suez, and Sociedad General de Aguas de Barcelona, S.A.	Water services concession	Aguas Cordobesas	France	Prevention from applying agreed mechanism of rate calculation (pesification of rates and suspension of adjustment clauses based on international parameters)
19	ARB/03/19	Aguas Argentinas, S.A., Suez, Sociedad General de Aguas de Barcelona, S.A. and Vivendi Universal, S.A.	Water services concession	Aguas Argentinas	France	Prevention from applying agreed mechanism of rate calculation (pesification of rates and suspension of adjustment clauses based on international parameters)

Annex (continued)

Order	Case Nº	Claimants	Sector or industry	Stakeholder firms	Bilateral investment agreement signed with	Main complaints
20	ARB/03/20	Telefónica S.A.	Telecommunications	Telefónica de Argentina	Spain	Prevention from applying agreed mechanism of rate calculation (pesification of rates and suspension of adjustment clauses based on international parameters)
21	ARB/03/21	Enersis, S.A. and others	Electricity distribution	Share in Distrilec Inversora (44.74%) and EDESUR (majority). Enersis is controlled in turn by ENDESA (Spain)	Spain	Suspension of adjustment clause agreed upon; prevention from calculating rates in dollars and from transferring remittances abroad
22	ARB/03/22	Electricidad Argentina S.A. and EDF International S.A.	Electricity distribution	Majority share in Electricidad Argentina (EASA), owner of EDENOR	France	Suspension of adjustment clause agreed upon; prevention from calculating rates in dollars and from transferring remittances abroad
23	ARB/03/23	EDF International S.A., SAUR International S.A. and Léon Participaciones Argentinas S.A.	Electricity distribution	Empresa Distribuidora de Electricidad de Mendoza	France	Suspension of adjustment clause agreed upon; prevention from calculating rates in dollars and from transferring remittances abroad
24	ARB/03/27	Unisys Corporation	Information storage and management project	Unyisis Latinoamérica SA	United States	Non-fulfilment of contractual obligations
25	ARB/03/30	Azurix Corp.	Water services concession	Share in OSM (32.08%)	United States	Prevention from applying agreed mechanism of rate calculation (pesification of rates and suspension of adjustment clauses based on international parameters)
26	ARB/04/1	Total S.A.	Gas production and distribution/ power generation project	Share in Central Puerto (63.93%); Hidroeléctrica Piedra del Aguila (41.30%); TGN (19.20%). Owner of TOTAL Austral and TotalGaz Argentina SA (which participate in different consortiums in the southern and Neuquén basins)	France	Prevention from applying agreed mechanism of rate calculation (pesification of rates and suspension of adjustment clauses based on international parameters)
27	ARB/04/4	SAUR International	Water services concession	Share in OSM (32.08 shares)	France	Pesification of deposits; application of exchange controls and prevention from transferring remittances; application of restrictions on crude exports; application of stamp tax by provinces; and prevention from deducting certain taxes.

Annex (continued)

Order	Case Nº	Claimants	Sector or industry	Stakeholder firms	Bilateral investment agreement signed with	Main complaints
28	ARB/04/8	BP America Production Company and others	Hydrocarbon concession and electricity generation project	PA Continental SRL; PA Sur SRL; PA Fueguina; Sociedades Argentinas de Petróleo y Gas. Share in Central Dock Sud SA	United States	Pesification of deposits; application of exchange controls and prevention from transferring remittances; application of restrictions on crude exports; application of stamp tax by provinces; and prevention from deducting certain taxes
29	ARB/04/9	CIT Group Inc.	Leasing enterprise	Controller of Argentine firm The Capita Corporation of Argentina (CCA)	United States	Discrimination in the application of economic emergency measures
30	ARB/04/14	Wintershall Aktiengesellschaft	Gas production	Share in hydrocarbons concessions	Germany	
31	ARB/04/16	Mobil Exploration & Development Inc. Suc. Argentina and Mobil Argentina SA	Gas production	Share in hydrocarbons concessions	United States	
32	ARB/04/18	France Telecom SA	Telecommunications	Telecommunications	France	
33	ARB/04/20	RGA Reinsurance Company	Financial reinsurance services	The firm extends life and disability insurance to the insurers of the Pension and Retirement Fund Administrator (AFJP) of Argentina	United States	
34	ARB/05/1	DaimlerChrysler Services AG	Leasing and financial services	DaimlerChrysler Services Argentina SA and DaimlerChrysler Leasing SA	Germany	
35	ARB/05/2	Compañía General de Electricidad SA and CGE Argentina SA	Electricity distribution	Empresa de Distribución Eléctrica de Tucumán SA; Empresa Jujeña de Energía; Empresa Jujeña de Sistemas Energéticos Dispersos SA and Energía San Juan SA	Chile	
36	ARB/05/5	TSA Spectrum de Argentina SA	Telecommunications	Thales – airspace control	Netherlands	
37	ARB/05/11	Asset Revovery Trust SA	Financial sector	Accused Banco de Mendoza, S.A. of cancelling contract	Germany – United States	

Source: Prepared by the author on the basis of World Bank/International Centre for Settlement if Investment Disputes, www.worldbank.org/icsid/about/about.htm

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The rights-based approach in development policies and strategies

Victor Abramovich

The so-called "rights-based approach" as applied in development policies and strategies treats international human rights law as a conceptual framework, accepted by the international community, that is capable of guiding policy formulation, implementation and evaluation in the field of development and, where international cooperation and aid are concerned, of providing guidance in relation to the obligations of donor and recipient governments, the extent of social participation and the oversight and accountability mechanisms required, both locally and internationally. This paper analyses certain points of connection and divergence between the development and human rights outlooks and seeks to establish some relationships between a number of fundamental rights (such as the right to equality, political participation and justice) and the concepts of inclusion, participation and accountability that development strategies often employ.

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I

Relationships and divergences between development and rights

This paper examines some issues that are currently the subject of debate in an effort to establish relationships between national and international development policies and strategies and international human rights law, and expresses some viewpoints concerning the relevance of this approach in the political, social and institutional context of Latin America.

Recently, many development agencies and international institutions, such as the Department for International Development (DFID) of the United Kingdom government, the Swedish International Development Cooperation Agency (SIDA), the United Nations Children's Fund (UNICEF), the United Nations Educational, Scientific and Cultural Organization (UNESCO), the United Nations Development Fund for Women (UNIFEM) and the Office of the United Nations High Commissioner for Human Rights (OHCHR), have discussed the need to strengthen this link and made major efforts in this direction, creating new conceptual frameworks for their action strategies that are based as far as possible on human rights principles, rules and standards.[1]

The so-called "rights-based approach" in development policies and strategies treats international human rights law chiefly as a conceptual framework that is accepted by the international community and that can provide a coherent system of principles and rules in the field of development. It also treats it as a broad guide to conducting the cooperation and aid process; social participation in that process; the obligations of donor and recipient governments; the method of evaluating aid; and the accountability mechanisms that need to be established at the local and international levels. One of the main advantages of this approach, then, is that it provides development strategies with an explicit conceptual framework that can yield useful inputs for thinking about the different components of that strategy: accountability mechanisms, equality and non-discrimination, and the involvement and empowerment of disadvantaged and excluded sectors. This conceptual framework could also be used to define more closely the obligations of States vis-à-vis the principal human rights involved in a development strategy: economic, social and cultural rights, and civil and political rights as well.

With the rights-based approach, broadly speaking, the view taken is that the first step towards empowering excluded sections of society is to recognize that they possess rights which are binding on the State. By introducing this concept, the idea is to change the logic of policymaking so that those for whom policies are intended are no longer viewed as people with needs who require help, but as possessors of rights who are entitled to demand particular forms of provision and conduct. Actions undertaken in this field are seen not just as a way of discharging a moral or political duty but as the method chosen to implement the imperative and enforceable legal obligations imposed by human rights treaties. Rights call forth obligations, and obligations need mechanisms to make them enforceable and put them into effect.

Although the various conceptual frameworks for the rights-based approach set out from different political and philosophical premises, and even differ in some cases in their definitions of poverty, what they do share is the idea that poverty deprives people of certain basic freedoms, both positive and negative, such as the freedom to avoid hunger, sickness and illiteracy, and that poverty is the result of economic but also cultural, social, legal and political factors. Although poverty is related to a lack of economic resources (personal income, for example), this does not necessarily mean that economic factors are the main drivers of poverty. Certain cultural practices and some political and legal frameworks that facilitate or encourage discrimination against certain individuals or groups, such as women,

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[1] See DFID (2000), UNHCHR (2004), Hunt, Nowak and Osmani (2002), Appleyard (2002), UNICEF (2001), UNESCO (2002) and SIDA (2001). Also, a distant forerunner of this approach is the gender view of development advocated since the 1970s by development agencies and multilateral organizations.

indigenous people or ethnic minorities, act as social exclusion mechanisms that cause or contribute to poverty.[2]

The different conceptual frameworks do not encompass all rights, but seek to identify those that are essential to development or poverty reduction strategies because they have a constitutive or instrumental relationship with poverty. Thus, for example, OHCHR (2004) specifies three different ways in which human rights can be relevant to these strategies: constitutive relevance, instrumental relevance and constraint-based relevance in respect of the content and scope of strategies. Some rights are of constitutive relevance because they relate to capabilities considered essential by the society concerned but are not enforced owing to a lack of economic resources (the right to food, for example, or the right to health). Other rights, such as certain civil and political rights, are of instrumental relevance because they help to prevent social or political processes that can lead to poverty. Thus, freedom of speech and the rights associated with the workings of representative democracy, with clean, periodic elections, make it less likely that society will tolerate situations of extreme poverty (famines, for example) without demanding responses from the government or activating mechanisms to impose social or political accountability. There are also rights that are of instrumental relevance because they facilitate social processes of consultation and evaluation that are essential when formulating anti-poverty policies or strategies: these are the rights of participation, information, and association or assembly. Lastly, certain rights are useful for strategies when they are able to restrict or limit the types of action permissible. Thus, for example, while it would be wholly reasonable for a very densely populated but resource-poor country to wish to adopt population control measures as part of its anti-poverty strategy, it would not be admissible for it to adopt measures like compulsory sterilization that violate people's physical integrity and privacy. In this way, certain rights whose non-enforcement is not itself a cause of poverty, and whose promotion may perhaps be without instrumental value for development and poverty reduction strategies, can have some influence on policy orientation by ruling out certain types of State intervention on the grounds that they are legally inadmissible.

One element that the different conceptual frameworks have in common is their adoption of the principle of interdependence between civil and political rights on the one hand and economic, social and cultural rights on the other, although the different frameworks do not by any means all place the same emphasis on the different categories of rights.[3] The rights to be taken into account, and priorities likewise, are usually determined in the light of the different development strategies so that, a priori, no one category of rights is given precedence over any other. This stance is supported by examination of a core of negative and positive obligations common to all categories of rights, which are grouped into three levels: obligations to be respected, to be protected, and to be complied with. Conceptual frameworks define from the outset, in greater or lesser detail, the main obligations deriving from the rights identified as relevant to the strategy concerned. On the basis of these obligations they set possible development targets and indicators as a reference for the targets and indicators that would need to be established in each local participation process.

Paradoxically, although they are concerned with many of the same issues, particularly poverty and exclusion and the way these relate to the political dynamic and the workings of democratic institutions, the disciplines of development policy and human rights have run in parallel, with few points of contact or connection. Many of the concepts that are habitual in development language, such as poverty reduction, participation, inclusion, good governance and accountability, refer to the very issues described in the field of rights as being concerned by the rights to health, food, education, freedom of speech, political participation, equality and non-discrimination, and justice, among others. On occasion, the language of rights has been considered too political and lacking in neutrality by some development agencies, and it is actually prohibited by the terms of reference of certain international financial institutions, such as the World Bank; however, this has not prevented the agendas of

[2] See Hunt, Nowak and Osmani (2002, chapter 1).

[3] Thus, for example, the conceptual framework produced by the Office of the United Nations High Commissioner for Human Rights spells out obligations, goals and indicators for economic, social and cultural rights. The same is true of the UNICEF studies, as the Convention on the Rights of the Child does not distinguish civil and political rights from economic, social and cultural rights. The conceptual framework of the DFID, on the other hand, while it makes frequent mention of economic, social and cultural rights, is organized around three core ideas, namely inclusion, participation and compliance with obligations, and strategy is not defined in relation to rights in particular. The rights referred to are discussed in relation to each of these three concepts.

these institutions from addressing problems of poverty or institutional quality that are directly linked to these rights.

Among the most insistent of the doubts raised about the potential for development policies to adopt a rights-based logic concerns the ambiguity of the content of obligations arising from economic, social and cultural rights. The prospect of such rights becoming as enforceable as civil and political rights is also called into question.[4] Again, it is suggested that a rights-based approach to public policy may sometimes prove too rigid and thus unduly trammel the discretionary powers of those who formulate development strategies. This subject will be returned to in section III. First, though, it needs to be said that there is an argument of substance behind these objections, since the relationship between human rights (particularly economic, social and cultural rights) and public policies is a thorny matter for which there is still not a sufficiently sound and consistent basis, whether in international law or in the constitutional law of the Latin American countries. Rights do not tell us much about the content of policies, but they can say something about their general orientation and provide a conceptual framework to guide their formulation and implementation.

Advocates of the rights-based approach understand that changing the perspective does not imply radical or sudden shifts in the practices that development agencies have been following in recent years, since they build on the points of connection and synergy between the development field and that of human rights. They argue that the obligations laid down by human rights treaties are not excessive and do not crowd out policy, but rather highlight the minimum measures which it is the duty of the State to implement. They also suggest that the main contributions of the rights-based approach to development strategies are the way it links rights to the empowerment of poor sectors and the way it strengthens accountability mechanisms by employing the international and national "institutional infrastructure" that exists in the field of human rights. They also take the view that human rights treaties and their interpretation by international bodies provide a clear, explicit framework that is recognized by all countries and enjoys a powerful social and political legitimacy, something that can only enhance the effectiveness of development strategies and the scope for coordinating State and non-State actors on the local, national and international stage.

[4] See ODI (1999).

If this approach were adopted in Latin American development strategies, there would certainly be a solid infrastructure to support it. In the region, the concept of human rights arose as a way of placing limits on the abuse of power by the State, as a catalogue of the types of conduct the State ought not to engage in: torture, the arbitrary taking of life, interference in private and family life, discrimination. This conception was linked with the resistance to military dictatorships in the Southern Cone in the 1970s and Central America in the 1980s.

In recent years, the corpus of principles, rules and standards that make up international human rights law has fixed more clearly not only the negative obligations of the State, but also a series of positive obligations. In other words, it has laid down more precisely not only what the State must not do, in order to prevent violations, but also what it has to do if civil and political rights and economic, social and cultural rights as well are to be fully effective. Thus, human rights are now regarded not just as a restraint on oppression and authoritarianism, but also as a programme that can guide or orient the public policies of States and help to strengthen democratic institutions, particularly during transitions or in incomplete or weak democracies.

As well as monitoring State activities very closely, many human rights organizations in the Latin American countries have initiated rewarding dialogues with governments in the hope of influencing the orientation of their policies and improving the workings of public institutions. The purpose behind this change of approach is to supplement their traditional work of reporting massive or systematic violations of rights with preventive and promotional action to forestall such violations. Similarly, the bodies that carry out international supervision of human rights, whether globally or regionally, have sought not only to provide victims with redress in particular cases, but also to establish a body of standards and principles in order to influence the quality of democratic processes and the efforts afoot to create more integrated, egalitarian societies.

This institution-building agenda has not always been a feature of the international oversight work carried out by the Inter-American Human Rights System, whose sole aim at times has been to provide a final legal recourse for victims of massive and systematic rights violations. However, this system does have intervention tools capable of significantly improving its conceptual contribution to public policymaking at the country level. Rulings by bodies in the system on a particular case have a heuristic value, as interpretations of the treaties by which conflict should be governed, that transcends the particular cases of the immediate victims. This international case law also tends to be taken as a guide for subsequent domestic rulings by national courts, which thereby seek to prevent States from being exposed to claims and possible adverse rulings before the international oversight authorities.

This globalization of human rights standards has unquestionably influenced the transformation of justice systems in the region's countries, and has made State authorities pay more attention to principles and rules established at the inter-American level. It has also contributed to the gradual creation of a State bureaucracy accustomed to dealing with these issues (human rights offices and commissions, ombudsmen and specialized officials), something that tends to influence certain aspects of public administration. At times, decisions adopted in a particular case do not merely interpret the provisions of the treaties governing the system, such as the American Convention on Human Rights, but also require States to formulate policies to remedy the situation which gave rise to the complaint. Requirements of this kind may consist in changes to existing policies, legal reforms and, often, alteration of certain patterns of behaviour by some State institutions that result in violations (e.g., police violence, abuse and torture in prisons, State acquiescence in situations of internal violence).

In relation to individual cases, the system usually favours amicable solutions or negotiations in which States often agree to introduce institutional reforms. In addition, the Inter-American Commission on Human Rights issues thematic and country reports and the Inter-American Court of Human Rights can issue advisory opinions which provide an opportunity to look beyond its casework and examine concrete issues in a wider context, and to determine the extent of the State obligations deriving from the Inter-American Convention on Human Rights and other human rights treaties applicable in the inter-American system. The case law and interpretations of the inter-American human rights bodies, both the Commission and the Court, have been a decisive factor behind the introduction of major reforms to the workings and accessibility of justice systems, increased respect for freedom of speech and access to public information, the abolition of provisions that discriminated against women, and recognition of the right of indigenous peoples to their ancestral lands and to political participation, among other issues of key importance for development in the region's countries (Méndez and Mariezcurrena, 2000).

In short, as was suggested earlier, the value-added or potential contribution of the rights-based approach in the field of development is manifold and may vary greatly depending on whose viewpoint and interests, among the different actors involved in development strategies, are considered: development agencies and institutions that finance development policies, States and other donors and recipients, or the different social and political actors involved. Furthermore, this approach will have differing degrees of influence on the content and orientation of public policies and on their preparation, implementation and evaluation. This being so, it is not the purpose of the present study to arrive at any definitive conclusions about a possible connection between development and human rights. It seeks only to explore the areas where greater linkage and synergy are possible, and to look briefly at some of the objections that have been brought against the rights-based approach.

The first step will be to analyse what the recognition of rights signifies, and the relationship between this and the empowerment of excluded sectors; this will be followed by an examination of the relationship between human rights, the obligations that derive from them, and public policies, with special reference to economic, social and cultural rights. Lastly, an attempt will be made to relate three issues that are fundamental to any development strategy, namely inclusion, participation and accountability, with some current legal debates in the region concerning human rights, specifically the scope of the right to equality and non-discrimination, social and political participation, and access to justice.

II

The logic of rights, empowerment, and enforcement mechanisms

The essential idea behind the adoption of a human rights approach to development and poverty reduction is that the policies and institutions employed to pursue strategies in this direction need to be based explicitly on the provisions and principles laid down in international human rights legislation. International law thus provides an explicit and imperative regulatory framework to guide or orient the formulation of national and international policies and strategies.

The need to empower the poor and excluded has been widely acknowledged in development and poverty reduction strategies. The human rights approach aims, essentially, to achieve empowerment through the recognition of rights. Once this concept has been introduced in a policy context, the essential starting point for policymaking is no longer the existence of sections of society that have unmet needs, but of people who have enforceable rights, i.e., entitlements that give rise to legal obligations for others and, consequently, to the establishment of safeguard, guarantee or accountability mechanisms. The objective here is to change the logic of the relationship between the State (or providers of goods and services) and the future beneficiaries of policies. These are no longer simply people with needs who receive welfare benefits or other forms of discretionary provision, but possessors of rights who have the legal and social power to demand certain forms of behaviour from the State.[5]

Before going into the specific debate about the meaning and scope of a rights-based approach, it is helpful to ask what is meant by possessing a right and what the main implications might be when the language of rights is used in the field of development and anti-poverty policy. Although the language of rights has an ethical and political value of its own and can strengthen social demands in the face of situations of inequity, its concrete implications for social relationships are not always given due consideration, and this creates a risk that the rhetoric of rights may not be followed up, so that the minimum expectations to which the concept may legitimately give rise are left unmet.[6] Recognizing rights usually means establishing legal or other measures to enable their possessors to seek redress from a legal authority or other similarly independent body if the party bound by them fails to discharge the obligations concerned. In other words, the rights-based approach establishes correlative obligations, non-fulfilment of which will activate different accountability or guarantee mechanisms. Consequently, recognizing rights also means empowering their owners in a specific sphere, and it can thus provide a way of restoring balances in social situations that display marked disparities. Unquestionably, too, recognizing rights does set some limits on the freedom of action of those they bind, including the State, since in some measure it broadly defines what they can and cannot do.

It is interesting to analyse this point in relation to economic, social and cultural rights and the techniques used to guarantee or protect these. The usual objection to their being recognized as rights, indeed, is that making certain social issues a matter of law may crowd out policy, limiting the ability of States to adopt effective anti-poverty and development strategies. The next section will deal synthetically with this issue. It should be said here, though, that the essential starting point for a rights-based approach is to recognize a direct relationship between the right, the correlative obligation and the guarantee, since this in turn will certainly contribute to the establishment of a conceptual framework for the formulation and implementation of public policies and accountability

[5] See Alsop and Norton (2004).

[6] Thus, for example, the Heads of Household Plan (Plan Jefes y Jefas de Hogar), the most important of the measures brought in by the Argentine government to alleviate the social crisis of 2001/2002, was presented as a way of recognizing the right of families to inclusion. Despite the use made of the term, though, there was no serious debate about the implications of recognizing a right to the benefits established by the plan, or about the difference –in terms of enforceability, for example– between this and the discretionary welfare benefits that had been the rule in earlier welfare policies (see CELS, 2004a).

mechanisms that can be considered compatible with the notion of rights. In short, when the language of rights is used in development strategies, there must be some kind of monitoring and accountability mechanism involving the actors in the policymaking process.[7]

III

Common obligations in the different categories of rights and the margin of discretion for public policy and development strategies

While the rights-based approach establishes a conceptual framework for the formulation and evaluation of development policies and strategies, it should not excessively trammel or limit governments' room for manoeuvre in their policymaking. The aim is not to force States or those upon whom rights impose obligations to go about things in a particular way, or to cramp the creativity of policymakers and strategists with rigid or inflexible systems. The prevailing view is that each State should have control of its own strategy, suggesting a relationship between the idea of "State ownership", rooted in the development sphere, and the right of self-determination. There are a number of ways to give effect to human rights in the framework of development policies and strategies. Thus, free-market systems and systems with greater State involvement in the economy can both meet the prescriptions of international human rights legislation.

The requirement arising from these rights, then, may be not specific measures but types of obligation that, while providing a direction, a route to be followed, a framework for decision-making, leave the State or those bound by the rights with a wide margin of discretion for selecting the specific measures that will be used to give effect to them. This is true both of civil and political rights and of economic, social and cultural rights, all of which entail a set of negative and positive obligations.

This is important as a starting point to provide a partial answer to doubts about the possibility of fully enforcing social rights, and to the criticism that political action is overly constrained by them. From this perspective, the differences between civil and political rights and economic, social and cultural rights are a matter of degree, not kind.[8] Obligations to act are the most visible facet of economic, social and cultural rights, and it is for this reason that they are sometimes known as "provision rights". When the structure of these rights is observed, however, it is easy to identify matching obligations to refrain from acting: the right to health entails a State obligation to do nothing harmful to health; the right to education entails an obligation to do nothing that worsens education; the right to preservation of the cultural heritage entails an obligation to refrain from destroying the cultural heritage. This is why the purpose of many of the legal enforcement measures taken in respect of economic, social and cultural rights is to correct State activity when it disregards obligations to refrain from acting. In summary, economic, social and cultural rights can also be described as a complex of positive and negative State obligations, although in this case the positive obligations are of greater symbolic importance in identifying them.

[7] An aid to understanding the problem is to follow the debate about the possibility of reading and enforcing the Millennium Development Goals, which do not use the language of rights, from a human rights perspective, to give them greater enforceability at the individual country level on top of the political commitment accepted by States (see Center for Human Rights and Global Justice, 2003).

[8] See Contreras Peláez (1994, p. 21): "There are, in short, no purely 'negative' obligations (or, better said, rights entailing exclusively negative obligations), but it does seem possible to posit a difference of degree as regards the relevance that benefits have for rights of one type or another."

Furthermore, the theoretical conception and even the practical legal regulation of a number of civil rights traditionally treated as "autonomy rights" or rights that generate negative obligations for the State has changed so much that some of the rights traditionally described as "civil and political" have acquired an unmistakably social cast. The way property rights have lost their absolute character when social considerations are at stake is the most complete example of this, although not the only one.[9] Current trends in tort law give a central place to the social distribution of risks and benefits as a criterion for determining the obligation of redress. The sudden emergence of consumer law has greatly altered contractual bonds when these concern the consumer and user relationship. The traditional consideration of freedom of speech and of the press has acquired social dimensions that are given substance when freedom of information is formulated as a right of any member of society, encompassing in some circumstances a positive obligation to produce public information. Freedom of enterprise and trade become conditional when their object or conduct affects health or the environment. In short, many rights traditionally classed as civil and political have been reinterpreted in the light of social considerations, making absolute distinctions meaningless in these cases as well. The jurisprudence of the international human rights protection bodies, in particular the European Court of Human Rights, has established a positive obligation on the part of States to remove social obstacles to jurisdiction, take appropriate measures to prevent environmental damage turning into a violation of the right to private and family life, and act affirmatively to forestall foreseeable and avoidable risks that may affect the right to life.

It might be said, then, that ascribing a particular right to the category of civil and political rights or to that of economic, social and cultural rights has a heuristic, organizing, classificatory value, but that a more rigorous conceptualization would reveal a continuum of rights in which the place of each was determined by the symbolic weight of the component of positive or negative obligations characterizing it.

In line with this, authors such as Van Hoof and Eide[10] propose a system of interpretation that identifies the "layers" of State obligations seen as characterizing the complex of obligations by which each right is identified, irrespective of whether it is classed among civil and political rights or among economic, social and cultural rights. According to Van Hoof,[11] for example, four "layers" should be distinguished: an obligation to respect, an obligation to protect, an obligation to fulfil and an obligation to promote the right concerned. The obligation to respect takes the form of a duty on the part of States not to interfere with, hinder or impede access to the enjoyment of the goods constituting the object of the right. The obligation to protect consists in preventing third parties from interfering with, hindering or impeding access to these goods. The obligation to fulfil means giving the possessor of the right access to the good when he cannot obtain this by himself. The obligation to promote is the duty of creating conditions whereby possessors of the right can access the good.

As can be appreciated, the idea of "layers" of obligations is perfectly applicable to the whole spectrum of rights, whether these are classified as civil and political rights or as economic, social and cultural rights.

It should be repeated that it is wrong to regard economic, social and cultural rights as rights that establish exclusively positive obligations. Both civil and political rights and economic, social and cultural rights constitute a complex of positive and negative obligations. Negative obligations are those that require the State to refrain from carrying out a particular activity, such as preventing the expression or dissemination of ideas, violating correspondence, practising arbitrary detention, preventing people from joining a union, intervening in a strike, worsening the health of the population, or denying people access to education. As for positive obligations, some distinctions should be established to point the way to the type of measures that can be demanded. Almost automatically, the positive obligations of the State tend to be linked directly to the obligation to make funding available. This is certainly one of the most characteristic ways of discharging obligations to act or provide, particularly in fields such as health care, education or housing.

[9] See the American Convention on Human Rights (Pact of San José, Costa Rica), art. 21.1: "Everyone has the right to the use and enjoyment of his property. *The law may subordinate such use and enjoyment to the interest of society*" (author's italics).

[10] See Eide (1995, pp. 21-49, and 1989).

[11] See Van Hoof (1984, p. 99). The distinction was originally suggested by Shue (1980). In the field of international human rights law, this distinction was incorporated (with some alterations that reduced the classification to three categories: the obligations to respect, protect and fulfil) in the main documents produced by the Committee on Economic, Social and Cultural Rights (United Nations) to interpret the International Covenant on Economic, Social and Cultural Rights.

However, positive obligations are not exhausted by the provision of budgetary reserves to make a service available. Service provision obligations may be characterized by the establishment of a direct relationship between the State and the beneficiary. The State may, however, provide for the enjoyment of a right by other means, with an active role perhaps being played by other agents bound by it. The possible measures a State may take to discharge positive obligations are manifold. Among others, they include organizing a public service (e.g., operating courts, which gives effect to the right to jurisdiction; providing official defence counsel, which gives effect to the right to defence in court for those who cannot afford their own counsel; or operating the public education system); providing development and training programmes; establishing graduated forms of public/private coverage (for example, by arranging private contribution methods to maintain social systems that cover the right to health of people in employment and their families, and establishing a public health system to cover the right of people not protected by the employment structure); operating a public system of credit with variable subsidies (for example, mortgage loans for housing); providing subsidies; carrying out public works; and providing tax breaks or exemptions.

It can be seen, then, that the logic of rights does not constrain the public policy options available to governments for discharging their obligations. States have a wide margin of freedom to decide what specific measures they will adopt to give effect to rights, and indeed this is essential to reconcile the rights-based approach with national decision-making processes for development and anti-poverty strategies.

International instruments set standards which are meant to guide public policymaking and then become the yardstick for interventions by oversight mechanisms (or possibly the judiciary) to determine whether the policies and measures adopted conform to them or not (for example, standards of “reasonableness”, “appropriateness”, “progressiveness” or “equality”, or of minimum content which may be established by the same international rules that establish rights). Thus, international human rights law does not specify policies, but lays down standards that serve as a framework for the policies set by each State. It is not the job of either oversight mechanisms or judges (should the case arise) to produce public policies; what they have to do is measure the policies adopted against the relevant legal standards and, if they find a discrepancy, ask the authorities to reconsider so that they can adapt their activities accordingly.

Faulty or failed policies do not always result in non-fulfilment of rights; this will only happen if the State ceases to comply with some or other of the obligations it has accepted. Conversely, there may be policies that are successful in achieving their objectives, but that embody measures which breach rights.

Without doubt, though, rights create frameworks for policy and thereby influence not just its content or orientation but also its formulation and implementation. To justify this assertion, it seems helpful to consider some legal debates concerning certain fundamental rights (such as the right to equality and non-discrimination, the right to political participation and the right to justice) that are now taking place in Latin America in relation to some of the problems raised by the application of certain core principles that guide public development strategies and policies, such as the principles of inclusion, participation and accountability.

IV

The inclusion principle and standards on equality and non-discrimination

The inclusion principle which usually governs development policies can be strengthened if it is linked to legal standards on equality and non-discrimination. International human rights law can be of service here by supply clearer concepts to serve as parameters for defining and evaluating public policies. What is required from the State is not only a non-discrimination commitment but also, in some cases, the adoption of affirmative measures to guarantee the inclusion of population groups or sectors that have traditionally been discriminated against. Although most of the region's countries have signed the main human rights treaties laying down standards for equality and non-discrimination, it is important to stick to the course laid down by the Inter-American Human Rights System in this area. Thus, in the *Morales de Sierra* case, the Inter-American Commission on Human Rights, in its interpretation of article 24 of the Inter-American Convention on Human Rights relating to equality before the law, established it as a principle that certain forms of difference or distinction in treatment (for example, those based on race or sex) created a strong suspicion of illegality, and that the State would have to put forward very weighty reasons to justify them. When the distinction concerned one of the factors or categories that aroused this suspicion (race, sex, national origin), the regulation or policy employing them would be subject to "heightened scrutiny". The case cited shows the potential of the system: it forced Guatemala to reform its civil code, which gave husbands exclusive administration of the marital union and imposed severe limitations on a married woman's right to work outside the home.[12] The same criterion applies to immigrant workers in the sphere of labour relations.[13] This has enormous political implications, given the situation of certain sections of society that have clearly been the victims of discrimination and exclusion through history, such as indigenous peoples in the Andean area or the black population in Brazil.[14]

The importance of all this lies in the fact that the inter-American system did not just uphold a formal notion of equality or confine itself to requiring objective and reasonable criteria of distinction and prohibiting unreasonable, capricious or arbitrary differences of treatment, but moved towards a material or structural conception of equality, setting out from the recognition that certain sections of the population required special measures of equalization. This implies the need to provide differentiated treatment when the circumstances affecting a disadvantaged group mean that equal treatment can only be achieved by restricting or worsening access to a service or good, or the exercise of a right.[15] The concept of material equality is a tool of enormous potential, both for examining the rules that confer recognition of rights and for orienting public policies that may uphold them or, sometimes, undermine them. In respect of individual members of groups that are vulnerable or likely to be discriminated against in their economic, social and cultural rights, the United Nations Committee on Economic, Social and Cultural Rights has established that the State has the obligation to bring in regulations that will protect them from this discrimination and to adopt special measures which include active protection policies.

One of the main obligations of the State is to identify groups that need priority or special help to exercise their economic, social and cultural rights at a given point in history and to see that its action plans incorporate concrete measures to protect these groups. This has been established, for example, by the Committee on

[12] Report no. 4/01, Case 11.625, *María Eugenia Morales de Sierra v. Guatemala*, 19 January 2001, Inter-American Commission on Human Rights.

[13] See Inter-American Court of Human Rights, *Advisory Opinion OC-18/03*, 2003.

[14] See Fry (2002, pp. 191-212) and Arias, Yamada and Tejerina (2004, pp. 215-236).

[15] For an analysis of these ideas, see Ferrajoli (1999, pp. 73-96), García Añón (1997), Fiss (1999, pp. 137-167) and Saba (2004, pp. 479-514).

Economic, Social and Cultural Rights in relation to a number of rights, in particular those concerning housing and public health. Before formulating its plans or policies in the social field, therefore, the State, as well as identifying sectors traditionally discriminated against in access to particular rights, will need to determine which are the sectors that require priority attention (for example, the inhabitants of a particular geographical area in the country, or people in a particular age group) and take measures to compensate them or strengthen their rights.

This obligation for States to adopt affirmative measures to support the exercise of social rights has important implications (for the type of statistical information that needs to be produced, for example). Preparing properly disaggregated information to identify sectors that are neglected or disadvantaged in the exercise of their rights not only helps ensure the effectiveness of a public policy, but is indispensable to allow the State to discharge its duty of giving special and priority attention to these sectors.

The principle of equality and non-discrimination will influence budget allocation and social spending criteria. Discrimination in access to rights may derive, for example, from disparities between geographical regions. In some Latin American countries, the decentralization of public-sector education and health care has heightened inequity in access to public services of comparable quality between the inhabitants of different geographical regions. An interesting exercise for measuring the usefulness of the rights-based approach is to review the impact of these public policies in the light of international standards on equality and non-discrimination. In respect of this, the Committee on Economic, Social and Cultural Rights has stated that the existence of acute disparities in spending policies that result in a different quality of education for the inhabitants of different areas may constitute discrimination for the purposes of the International Covenant on Economic, Social and Cultural Rights.

V

The participation principle and its relationship with civil and political rights

The participation principle is crucial to development strategies and policies, as a method of identifying needs and priorities at the local or community level. This core principle can be delineated by its link with the exercise of particular civil and political rights and, in particular, by the content and scope of some of these rights as specified by international human rights protection bodies. There are also some concrete rights of participation and consultation in public policy decision-making processes that are explicitly defined in international or constitutional norms.

It is essential, then, to analyse the extent to which certain sectors that are subject to discrimination or social exclusion in Latin America, and that are usually identified as beneficiaries of development measures, are especially hindered from exercising some of these rights, since this severely limits the success of the formal consultation and participation mechanisms usually provided for in development strategies.

Unquestionably, the political participation necessary in a democracy requires more than an institutionalized system of clean, periodic elections. It is essential for people to have the opportunity to exercise certain other rights that are, in their way, prerequisites for a more or less smoothly functioning democratic process: the right of association and assembly, freedom to unionize, and freedom of speech and information, among others. If these rights can be exercised in practice then the poorest sectors will be able to influence political processes and the stance of government decision-making, but the ability to exercise them will be conditioned or constrained by the degree to which these sectors are actually in a position to assert their economic, social and cultural rights.

The right of association, and the freedom to unionize in particular, are very important in securing social participation and the exercise of basic social rights for the poor. Now that the Protocol of San Salvador has come into force, the inter-American system has the opportunity to examine cases concerning union freedom (including the right to strike and the right to collective bargaining) from most of the Latin

American countries and to establish uniform jurisprudence in this area that is binding throughout the region. The Inter-American Court of Human Rights, indeed, has already pronounced on a case from Panama concerning the freedom to unionize.[16]

Another key to the political participation of excluded sectors in Latin America is the scope of the rights of assembly and free speech, given the practice in some countries of placing restrictions on public demonstrations. In a recent report, the Special Rapporteur for Freedom of Expression of the Inter-American Commission on Human Rights sought to balance the civil rights at stake with the interest of the State in maintaining public order by laying down the principle that criminalization (i.e., the use of criminal prosecutions to deal with social protests) should be a last resort, used only if an imperative public interest has been demonstrated.

One issue that has aroused concern in the inter-American system has been indigenous peoples' exercise of the right to be consulted on policies that might affect their cultural territories, such as those that result in economic and natural resource exploitation, and to conduct discussions with State authorities and other social actors through their own political representatives (Aylwin, 2004, pp. 153-222). The Inter-American Court of Human Rights has established that States are obliged to have appropriate participation and consultation mechanisms for indigenous peoples in relation to decisions that may affect the use of their natural resources or in some way alter their traditional territories.[17] The Court has also reaffirmed the obligation of States to adopt positive measures to ensure that members of indigenous communities can participate on equal terms in decision-making about matters and policies that affect or may affect their rights and the development of these communities, so that they can be represented in State bodies and institutions and participate directly and in proportion to the size of their populations in the management of public affairs through their own political institutions and in accordance with their values, usages, customs and forms of organization.[18]

To include all sections of society in political and social development processes, an essential tool is proper access to public information and the steady release of the kind of information needed for evaluating and monitoring policies and decisions which directly affect them. Although access to information is a clear principle of development strategies, approaching the subject from the standpoint of rights may improve the orientation of transparency policies and create pressure for the institutional changes that are needed in the different countries of the region. Paradoxically, even though most of these countries have ratified the main international instruments embodying civil rights, very few have laws on public information access or domestic regulations that go beyond minimum legal standards in this area. Recently, some useful studies have set out to establish the scope of the fundamental right of access to information held by the State, as enshrined in international human rights law. One of the most important of these studies is that produced by the Special Rapporteur for Freedom of Expression of the Inter-American Commission on Human Rights on the basis of article 13 of the American Convention on Human Rights, as it provides a parameter to which laws on public information access in the region's countries should conform.

[16] Inter-American Court of Human Rights, *Baena Ricardo et al.* case, judgment of 2 February 2001, Series C, No. 72.

[17] Inter-American Court of Human Rights, *Mayagna (Sumo) Awas Tingni Community* case, judgment of 31 August 2001, Series C, No. 79.

[18] Case of *Yatama v. Nicaragua* of 23 June 2005.

VI

The accountability principle and mechanisms for enforcing rights

To explore the potential of the relationship between rights and development policies, it is essential to consider accountability mechanisms. This is because the logic of rights, as already pointed out, necessarily requires that there be mechanisms to enforce them. These mechanisms help strengthen policy oversight, public services and the actions of both governments and the other social actors involved in development strategies. What is meant here by rights enforcement mechanisms are not just systems for administering justice, although these might have a very important role; the concept also includes, among other instruments, administrative procedures whereby decisions are reviewed and citizens exercise oversight of policies, user and consumer complaint procedures, parliamentary bodies that monitor policy and specialist institutions that protect fundamental rights (ombudsmen, consumer protection and competition authorities, etc.). Particular consideration is merited by the rights protection systems operating at the international level, such as the Inter-American Human Rights System and the thematic committees and rapporteurs of the United Nations, among others. It is clear that the suitability of the different mechanisms for monitoring public policies and ensuring that these respect rights depends not only on their institutional characteristics, but also on their appropriation by social organizations and the existence in civil society of actors with the desire and resources to use them. We shall now highlight some aspects that are deserving of analysis.

International human rights rules are quite specific about the right to legal and other resources that offer an appropriate and effective channel for actions over breaches of fundamental rights. The State has not only a (negative) obligation not to hinder access to these resources but also, and vitally, a (positive) obligation to organize the institutional machinery in such a way that everyone, and especially those who are in a situation of poverty or exclusion, can access these resources. To discharge its duty, it must remove any social or economic obstacles that hinder or limit access to justice and, in some cases, even take it upon itself to provide legal advice or establish systems to exempt people from legal costs.

Before anything else, it needs to be remembered that social policies, and indeed State education and health provision, have not been guided in their organization and operation by the logic of rights. Indeed, services have mostly been organized and provided in accordance with the opposite logic, that of welfare, so that, subject to certain institutional controls, this field of action for public administrations has traditionally been the preserve of policymakers acting on their own discretion. The subject is complex and cannot really be understood in the same way in all the region's countries. The expansion of the social functions of the State (in areas such as health, housing, education, work, social security, consumption and measures to encourage participation by disadvantaged social groups) has not necessarily translated, technically speaking, into the specific configuration of rights.

In many cases, the State took on these functions as a result of discretionary initiatives or methods of organizing activities –such as the provision of public services, or the creation of targeted social plans or programmes– whose social and economic effects are not intended to discharge a duty towards possessors of rights, whether individual or collective. What has often happened is that types of provision or action considered to be entitlements by national constitutions or human rights covenants have been treated by States as discretionary or manipulated for purposes of political patronage.[19] It is not impossible either in theory or in practice, however, to design enforceable rights in these fields as well, thereby supplementing institutional, administrative or political supervision mechanisms with such oversight as may be exercised over providers or

[19] See Ferrajoli (2003, pp. 11-21). One possible reading of current efforts to dismantle welfare States from this perspective would emphasize not just cutbacks in social services but also the weakening of the legal bond between the State and the intended beneficiaries of the social policies concerned. A clear instance of this is the shift from universal social policies based on recognition of subjective rights to targeted and temporary social programmes based on discretionary interventions by the public authorities. See Lo Vuolo, Barbeito and others (2000, pp. 191-202).

officials by people exercising rights linked to this type of social provision.

The purpose of recognizing rights in constitutions and treaties is to impose obligations on the public authorities, whence the need to require that these rights be configured in such as way as to make them enforceable. There is absolutely no reason not to recognize the possibility, at the social policy level, of demanding civil rights such as the right to equality and non-discrimination and the right to information, and social rights that create frameworks and minimum standards for these policies. Unquestionably, the inclusion of a rights perspective in the design of plans ought to mean that basic criteria of due process are incorporated into their institutional engineering, including a reasonable time limit, the right to know the reasons for a decision, the right to review by an independent authority (ultimately perhaps the judicial authority), the right to information about the resources available, and the principle of equality of arms.[20]

In the European Union (EU) there have been some notable experiences involving the creation of conceptual frameworks for access to justice and the enforcement of social rights, which serve as a parameter for oversight by EU bodies of the workings of individual countries' social services and policies.[21] Frameworks of this kind could also be produced in Latin America, guided by the standards of the inter-American system.

At the same time, recognizing that these policies and services are the fulfilment of economic, social and cultural rights will also mean recognizing appropriate mechanisms for enforcing these individual and collective rights. This issue should be given the highest priority in the region's legal reform agenda, to improve access to justice and social participation in the oversight of State policies and of the actions of private agents that affect the exercise of these basic rights. Among the mechanisms for securing access to justice on issues related to development and anti-poverty policies, reference may be made here to collective actions brought on the grounds of unconstitutionality (*amparo*) or class actions, which can be used to challenge the legality of certain aspects of public social policies or public service provision on the basis of constitutional or international standards. By means of such actions, some environmental organizations, user groupings, indigenous peoples and women's and human rights organizations have successfully influenced the orientation of social policy; held to account public service companies and, in some cases, private businesses and groups engaging in activities with environmental effects; and indeed demanded information and participation mechanisms so that they could become involved in the preparations for policymaking or the awarding of concessions for potentially harmful economic activities.

Another key to improving accountability mechanisms in development and anti-poverty strategies is the enhancement of international protection systems for human rights, not just as a final resort when national legal systems have failed, but as a means of establishing uniform standards for the rights enshrined in treaties. These standards would subsequently be applied by national legal systems and would help strengthen local democratic institutions. The idea, then, is to improve the protective workings of international mechanisms, but at the same time to steer governments towards compliance with these rights and strengthen the mechanisms used to protect individuals within countries, the application of treaties by national courts, the incorporation of the jurisprudence built up by the system in the rulings of constitutional courts, and use of the principles underlying this jurisprudence to guide public policies (via specialized agencies such as human rights ministries and ombudsmen, for example). The duty of States to adapt their policies and legal systems to the obligations accepted under international treaties can have very real implications for accountability systems. One positive instance of this kind is the work undertaken by UNICEF to implement the Convention on the Rights of the Child at the national level, and the concern to generate standards and rules for the proper interpretation of its provisions at the local and international levels. The experience of the so-called Aarhus Convention[22] may also be useful to the region; it set minimum common

[20] See CELS (2004b) at www.cels.org.ar. This study analyses the administrative procedures for assigning social pensions from the standpoint of the due process standards laid down by Argentine constitutional jurisprudence and the inter-American system of human rights. Social oversight systems based on the logic of rights may have points of contact, but also differences, with the social accountability mechanisms traditionally considered by international financial institutions. See Ackerman (2004) for an examination of these differences.

[21] See the document by the Group of Specialists on Access to Social Protection (n/d). CDCS (2004) may also be consulted. See likewise Daly (2002).

[22] The Convention on Access to Information, Public Participation in Decision-making and Access to Justice in Environmental Matters (Aarhus, Denmark, 1998) was originally approved at the United Nations and then adopted as a guide by the European Union. Of particular interest is the work done by the working group of signatory States on implementation of the Convention at the national level.

standards for information access, civic participation and access to justice in environmental matters, and has served as a guide for international oversight of national policy formulation and implementation in this field.

In summary, it is not difficult to build bridges and establish relationships between the field of human rights and the principles that usually orient or guide development policies and strategies. Whether these two spheres actually come together as they might will largely depend on whether the decision is made to change the logic behind certain public policies and their levels of universality, transparency and oversight. Also crucial to this potential encounter will be a deepening of the role that international human rights monitoring bodies can play by setting clearer and more precise minimum standards for matters of common interest and thereby providing a framework for State policies and a yardstick for their oversight and evaluation.

(Original: Spanish)

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Can the Latin American and Caribbean countries emulate the Irish model of FDI attraction?

Ruth Rios-Morales and David O'Donovan

In the era of globalization, foreign direct investment (FDI) is an essential factor in the development of the economy. In recent years, creating a better investment climate has therefore been a policy priority for many governments, including the Latin American ones. Only a very small group of Latin American countries have attained relative success in attracting quality FDI, however. Conversely, Ireland has achieved impressive results by creating an attractive environment for FDI. The Latin American countries would do well to emulate the Irish experience, especially as regards the approach to establishing competitive advantages and efficiently promoting the country as a market site for FDI.

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I

Introduction

The process by which a small nation leveraged itself to a position among the world's leading economies in the era of globalization indeed warrants examination. One of Europe's poorest nations in the 1960s, today Ireland is one of the wealthiest nations in the world with an annual per capita income of US$ 36,360 (UNDP, 2004, table 1). Ireland has built its once largely agriculture-based economy up into a sophisticated model grounded mainly on advanced technology and services. Today the industrial sector generates 47% of GDP and absorbs 28% of the workforce. The services sector contributes 46% of GDP and accounts for 65% of employment, whereas the agricultural sector represents 5% of GDP and just 7% of employment.[1]

In 2004, Ireland was also one of the few economies in the world to record a large trade surplus, equivalent to 38.4 billion euros (CSO, 2005). Much of this spectacular achievement has been attributed to the role of FDI in Ireland's economy. To a large extent, however, this success has resulted from a holistic approach to the implementation of industrial policies in combination with consistent macroeconomic measures, as well as a favourable external sector that attracted high-valued added FDI.

At the same time as Ireland was notching up successes, Latin America, which is regarded as the most open region in the developing world, was having an entirely different experience. After accounting for the developing world's largest share of FDI flows (14%) in the 1970s, in the 1980s Latin America and the Caribbean began to lose its pull, capturing only 7.49% of world FDI inflows. The region's share rose again with the FDI boom of the 1990s, but never recovered the level seen in the 1970s. Since 1999, the Latin American and Caribbean region has been experiencing serious difficulties in attracting foreign investment, even though its FDI flows increased by 40% in 2004. While the developing world in general has increased its share in FDI inflows, in 2003 Latin America's share decreased considerably, to around 8% (see table 1). More recent studies suggest that Latin America's share fell to about 6% in 2004 (IBM/PLI, 2005).

The evidence suggests that Latin American governments focused on short-term macroeconomic priorities and took a "the more the better" approach to FDI. By contrast, Ireland implemented policies that took account of long-term national development goals and aimed to attract quality investment. Most importantly, the Irish Government adopted a holistic approach to development and examined all new economic and industrial policy initiatives in the light of their probable effect on Ireland's attractiveness as an investment location.

In the era of globalization, FDI spillovers are largely absent in Latin America (ECLAC, 2003 p.20; 2004, p.29), whereas in Ireland, such spillovers were absorbed into the local economy and played an important role in economic growth.

Creating a better investment climate has been a policy priority for many governments, including the Latin American ones, in recent years. The role of FDI in a country's economy is widely recognized and, more recently, it has been acknowledged as contributing to poverty reduction. FDI alone will not produce economic development or reduce poverty, however. What it will do is generate a positive contribution to economic growth in the host country when FDI policies form part of the economic development strategy (Willem te Velde, 2001). Creating the conditions to foster economic development has produced excellent results in Ireland, and Latin America would do well to emulate the Irish experience where relevant.

This paper is intended to highlight important aspects of the Irish experience that may be applicable in Latin America. Following the introduction, section II assesses the role of FDI in the economy. Section III looks at recent trends and determinants of FDI in developing countries, section IV evaluates FDI strategies in Latin America and section V identifies policy failures in Latin America in the era of globalization. Section VI examines the Irish model of FDI attraction, highlighting the importance of the work of promotional agencies. Section VII sets out the lessons the Latin American countries can learn from the Irish experience. Section VIII contains the main conclusions and recommendations.

[1] See www.idaireland.com.

TABLE 1

World: FDI inflows by regions and major countries

(Millions of dollars)

Region/economy	1970-1979	%	1980-1989	%	1990-1999	%	2000-2004	%
World	241 244.2		938 874.0		4 010 278.7		4 219 336.0	
Developed countries	**180 086.3**	**74.6**	**724 613.1**	**77.2**	**2 669 291.8**	**66.6**	**3 100 554.0**	**73.5**
Australia	10 382.9	4.3	37 180.0	4.0	62 154.1	1.5	83 776.0	2.0
Belgium and Luxembourg	8 651.2	3.6	22 451.5	2.4	227 093.0	5.7	176 942.0	4.2
Canada	32 346.2	13.4	37 822.9	4.0	106 090.9	2.6	128 603.0	3.0
Denmark	1 078.6	0.4	2 291.1	0.2	42 604.9	1.1	43 845.0	1.0
France	14 352.2	5.9	38 180.6	4.1	226 983.0	5.7	209 577.0	5.0
Germany	14 363.9	6.0	15 139.9	1.6	124 615.0	3.1	263 915.0	6.3
Ireland	1 370.2	0.6	2 209.5	0.2	38 946.1	1.0	100 419.0	2.4
Italy	5 882.2	2.4	18 872.7	2.0	39 497.1	1.0	76 020.0	1.8
Japan	1 240.0	0.5	1 806.0	0.2	26 318.8	0.7	37 943.0	0.9
Netherlands	9 578.3	4.0	27 319.3	2.9	154 328.3	3.8	155 545.0	3.7
Spain	5 782.9	2.4	33 814.4	3.6	105 723.5	2.6	158 951.0	3.8
Sweden	766.9	0.3	7 063.8	0.8	130 093.7	3.2	47 808.0	1.1
Switzerland	0.0	0.0	9 411.1	1.0	44 418.6	1.1	55 430.0	1.3
United Kingdom	32 571.8	13.5	103 919.5	11.1	324 768.9	8.1	294 114.0	7.0
United States	32 190.0	13.3	336 805.0	35.9	890 636.0	22.2	697 492.0	16.5
Developing countries	**61 091.8**	**25.3**	**213 561.7**	**22.7**	**1 217 689.9**	**30.4**	**1 026 116.0**	**24.3**
Latin America and the Caribbean	*32 694.5*	*13.6*	*74 381.1*	*7.9*	*444 322.1*	*11.1*	*351 580.0*	*8.3*
Argentina	1 305.6	0.5	5 844.0	0.6	68 130.5	1.7	20 874.0	0.5
Brazil	12 698.4	5.3	17 214.2	1.8	99 216.5	2.5	100 136.0	2.4
Chile	590.6	0.2	4 376.1	0.5	32 466.9	0.8	23 598.0	0.6
Mexico	6 015.0	2.5	23 873.0	2.5	90 647.5	2.3	87 520.0	2.1
Venezuela (Bolivarian Republic of)	-1 047.9	-0.4	1 562.7	0.2	21 426.0	0.5	13 343.0	0.3
Asia and the Pacific	*17 737.5*	*7.4*	*117 559.1*	*12.5*	*711 497.1*	*17.7*	*595 794.0*	*14.1*
China	0.1	0.0	16 186.5	1.7	290 427.0	7.2	254 470.0	6.0
Hong Kong, China	2 676.4	1.1	21 332.7	2.3	90 327.9	2.3	143 041.0	3.4
India	372.6	0.2	1 047.5	0.1	15 165.7	0.4	18 775.0	0.4
Korea, Republic of	1 094.0	0.5	3 305.0	0.4	24 150.0	0.6	26 730.0	0.6
Malaysia	3 261.9	1.4	9 647.4	1.0	48 158.0	1.2	14 642.0	0.3
Singapore	3 013.0	1.2	19 068.0	2.0	83 989.5	2.1	61 818.0	1.5
Taiwan Province of China	658.7	0.3	4 717.0	0.5	14 591.0	0.4	12 833.0	0.3
Thailand	798.2	0.3	5 098.6	0.5	31 822.4	0.8	11 199.0	0.3
Africa	*10 659.8*	*4.4*	*21 621.5*	*2.3*	*61 870.7*	*1.5*	*78 742.0*	*1.9*
South-East Europe and Commonwealth of Independent States (CIS)	..	..	*78.0*	*0.0*	*52 212.0*	*1.3*	*92 666.0*	*2.2*

Source: UNCTAD (2005b).

II

The role of FDI in the economy

In the era of globalization, FDI is regarded as an essential factor in economic development. It is conceded that FDI can generate employment, enhance exports and contribute to long-term economic development (World Bank, 2005). More recently, the spillovers of FDI have come to be considered a powerful motive for encouraging foreign investment, as FDI seems to bring knowledge, managerial skills, marketing strategies, and distribution and production networks that benefit the host economy (Blomström, 2001). For most countries, therefore, creating a better climate for FDI has become a central part of economic development.

Turning FDI into an instrument of economic development takes more than making a country an attractive market site for investment. Creating a better environment for FDI requires a holistic approach to the implementation of industrial policies (property rights legislation, reduction of red tape, and corporate tax system) and macroeconomic measures (liberalization, deregulation, availability of infrastructure and skilled labour force). The importance of policy coordination cannot be overstated. This is necessary to ensure that impacts are not diluted or even cancelled out by conflicting effects flowing from uncoordinated polices. Coordination has to take place both within and among different branches of the national government, as well as within and between different local government departments. Moreover, in order to make FDI an instrument of economic growth, long-term economic development goals have to be set in the light of national priorities. FDI will generate a positive contribution to economic growth only when the necessary conditions for economic development are implemented and the domestic economy is ready to absorb spillovers (Willem te Velde, 2001).

In some cases, the premise that FDI contributes positively to the economy by creating new jobs and fuelling economic expansion is more illusory than real. For instance, much of the FDI going to Latin America in the last few decades has been attracted by privatizations (Athukorala and Rajapatirana, 2003). This has modernized a number of sectors, but privatization represents merely a change of ownership and not necessarily an increase in physical production capability (UNCTAD, 1999). FDI has not automatically contributed to job creation or increased exports, therefore.

The positive effects of FDI on economic growth are not automatic. They depend on the host country's trade regime (Balasubramanyam, Salisu and Sapsford, 1996), level of education and human capital conditions (Borensztein, de Gregorio and Lee, 1998), technological development (De Mello, 1997), export-oriented intensity of FDI received (Willem te Velde, 2001) and macroeconomic stability (Zhang, 2001). Similarly, the assumption that FDI will always generate positive spillovers in the economy of the host country has been proven wrong. Empirical research has found that in some cases FDI spillovers can have negative effects in the host country (Aitken and Harrison, 1999; Saggi, 2000). Other studies note that potential spillovers will only materialize if local firms are primed to absorb the skills and technology generated by FDI (Blomström and Kokko, 2003; ECLAC, 2004, p.29).

III

Recent trends and determinants of FDI in developing countries

There have been major changes in the trends and determinants of FDI worldwide. Even though developing countries gained a larger share in total inflows of FDI in the 1990s, the developed countries continue to account for the largest portion of foreign investment (see figure 1). During this period, the Latin American countries' attractiveness to investment declined somewhat, as they lost ground to countries of the Asia-Pacific region, with China being the favourite for foreign investors. Today, China is the single largest recipient of FDI inflows in the developing world, attracting about 25% of total foreign investment.

A positive outlook was forecast for Central and Eastern Europe, since this region benefited in the 1990s from rapid growth of FDI inflows, but these flows have declined since 2000 (UNCTAD, 2004). Africa is experiencing similar difficulties to Latin America. Although many African countries have implemented economic reforms and policies to create a better climate for foreign investors, the region has not secured a significant volume of FDI . Notwithstanding the common argument that African countries have an FDI-hostile environment (Jenkins 2002), the real reasons for their lack of success have more to do with the fact that the determinants of FDI have changed and multiplied, and that market-site competitiveness requires efforts in many areas.

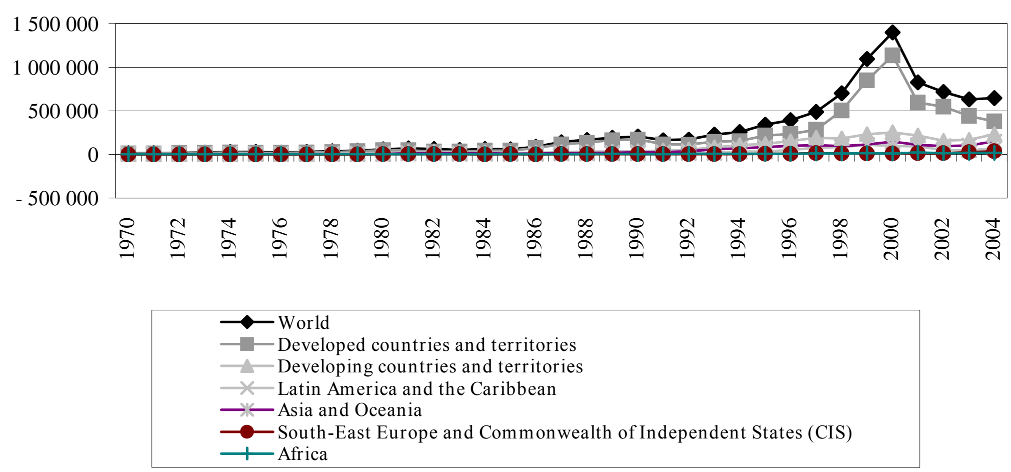
At present, a prominent characteristic of FDI is that the bulk of foreign investment in developing countries has gone to a limited number of countries (Addison and Heshmati, 2003). In the global economy, a country's overall attractiveness as a potential market site for FDI depends on the balance of benefits, costs, and risks associated with doing business there. Although the rapid growth of the global economy has changed the factors that influence FDI in developing countries, the longstanding determinants of foreign investment, such as natural resources, country location and infrastructure, remain important in the assessment of a potential market site (Nunnenkamp and Spatz, 2002). Nevertheless, these longstanding determinants are not sufficient in themselves to create an attractive market for FDI.

A long list of requirements have to be met in order to create a better climate for FDI. Recent literature on

FIGURE 1

World: FDI trends, 1970-2004

(Millions of dollars)



Source: UNCTAD (2005b).

this topic identifies institutional features as new and significant determinants of FDI. Such features include the degree of political stability, government intervention in the economy, trade openness, property rights legislation, red tape and the corporate tax system (De Mello, 1997; Rodrik, Subramanian and Trebbi, 2002). Recent work on incentives for FDI signal corruption as an important deterrent (Mauro, 1995; Oman, 2000; Church, Gandal and Krause, 2002), even though some countries have succeeded in attracting foreign investment despite evidence of this problem (Kolstad and Villanger, 2004). This suggests that certain market site characteristics are associated and weighted differently by investors balancing the benefits, costs, and risks associated with foreign investment.

Education and training are also new and important factors on the list of determinants of FDI in developing countries. Numerous studies[2] have identified education and training as vital influences on FDI in the new global economy. For instance, an influential research report prepared by Professor Magnus Blomström and published by the Organisation for Economic Co-operation and Development (OECD) concludes that developing country governments should focus on education and training in order to create the strongest potential market site for FDI (Blomström M. 2001, p. 178). By enhancing education and, hence, human capital, governments can encourage export-oriented FDI and thus help to maintain macroeconomic stability (Zhang, 2001).

Regional and bilateral agreements have also been important in improving the investment climate in many countries (Ethier, 1998). The number of trade agreements signed by developing countries has increased dramatically in recent times. According to the *World Investment Report 2005* (UNCTAD, 2005a), more than 2,392 bilateral investment treaties now exist. The World Trade Organization (WTO) estimates that over 300 regional trade agreements will be in effect by 2007.[3] Regional agreements have important influence on the location of foreign investment. Research conducted by Hallward-Driemeier (2003) empirically tested the influence of bilateral agreements on increasing FDI inflows to developing countries and concluded that such treaties complement good institutional features, but cannot substitute for them.

IV

FDI strategies in Latin America and the Caribbean

A modified version of Dunning's model (1988) will be used to assess different factors involved in attracting FDI in Latin America and the Caribbean in the recent period. This version of the model categorizes FDI by four different strategies, depending on the objective it seeks: (i) access to natural resources; (ii) market expansion; (iii) greater efficiency; or (iv) technological assets. In recent years, the Latin American and Caribbean region has attracted FDI seeking natural resources, market expansion and efficiency. Efficiency-seeking FDI is most prominent in Latin America's foreign trade and has been attracted by only a few countries. No significant technological asset-seeking investment appears to have been recorded in Latin America.

1. Natural resource-seeking investment

During the last 100 years, natural resources have been the main driver of FDI in Latin America (ECLAC, 2004). TNCs have invested in petroleum, gas, and the mining industry, particularly in the Southern Cone (see table 2).

Lately, foreign investors have shown mounting interest in exploiting natural gas. Since the discovery of gas reserves in Argentina, Bolivia, Brazil, Ecuador, Colombia and Peru in the 1990s, international hydrocarbons firms have become increasingly keen to invest in gas in the southern part of the region. The French company Totalfina has been the largest investor in the sector, exploring and exploiting hydrocarbon reserves mainly in Argentina, Bolivarian Republic of Venezuela, Bolivia, Colombia and Trinidad and Tobago. Petrobas, a Brazilian State-controlled Latin American

[2] Borensztein, De Gregorio and Lee (1998); Noorbakhsh, Paloni and Youssef (2001); Blomström (2001); Zhang (2001); Addison and Heshmati (2003).

[3] See http://www.wto.org/english/tratop_e/region_e/regfac_e.htm.

TABLE 2

Latin America and the Caribbean: FDI strategies

Strategies	Natural resource-seeking	Local market-seeking	Efficiency-seeking
Sectors			
Goods	*Petroleum and gas:* Andean Community, Argentina, Trinidad and Tobago	*Automotive*: MERCOSUR	*Automotive*: Mexico
		Chemical: Brazil	*Electronics:* Mexico and Caribbean Basin
	Mining: Andean Community, Chile and Argentina	*Food industry*: Argentina, Brazil and Mexico	*Clothing:* Mexico and Caribbean Basin
		Beverages: Argentina, Brazil and Mexico	
		Tobacco: Argentina, Brazil and Mexico	
Services	*Tourism:* Mexico and the Caribbean Basin	*Finance:* Argentina, Bolivarian Republic of Venezuela, Brazil, Chile, Colombia, Mexico and Peru	*Back-office services:* Costa Rica
		Telecoms: Argentina, Bolivarian Republic of Venezuela, Brazil, Chile and Peru	
		Retail commerce: Argentina, Brazil and Mexico	
		Electric power: Argentina, Brazil, Chile, Colombia and Central America	
		Gas distribution: Argentina, Bolivia, Chile and Colombia	

Source: ECLAC (2005, table I.6).

TNC, is a key player in the development of the region's gas industry. Petrobas has invested in Angola, Argentina, Bolivarian Republic of Venezuela, Bolivia, Ecuador, Nigeria, Peru and the United States, and ranks number 144 among the world's top 500 firms (ECLAC, 2004). Mexico and the Caribbean Basin were the main market sites for FDI in the tourist sector.

Most natural resources continue to be exported mainly as raw material. This type of investment therefore creates very little value added in the Latin American economies (ECLAC, 2004). Consequently, positive-spillover effects in terms of technology transfer and absorption, production linkages, human resources training and local business development have been lacking in the region (ECLAC, 2004, p.43). *Foreign Investment in Latin America and the Caribbean, 2004* (ECLAC, 2005) notes that spillover has been absent even in Mexico and the Caribbean Basin, which have succeeded in attracting efficiency-seeking investment.

2. Market-seeking investment

Local market-seeking companies invest more in Latin America, proportionally speaking, than the other categories of investors. TNC food manufacturers have targeted markets with large populations, such as Brazil, Mexico and Argentina, while the Southern Common Market (MERCOSUR)[4] has attracted the automotive industry (see table 2). The most prominent firms, however, are those seeking local markets in the services sector. These companies have invested mainly in the banking system, telecommunications, electric power and gas distribution.

During the period 1996-2003, the distribution of FDI flows coming into Latin America and the Caribbean

[4] In March 1991, Argentina, Brazil, Paraguay and Uruguay signed the Treaty of Asunción creating MERCOSUR, which has opened up opportunities for firms to expand their markets.

shifted towards services, which accounted for 59% of total inflows, while manufacturing received 28% and the primary sector 13% (ECLAC, 2004). The main sources of FDI flows into Latin America and the Caribbean have also changed. Although the United States continues to be the largest single contributor, accounting for about 33% of total FDI in the region (ECLAC, 2004), investment from Europe has grown strongly since the privatizations. Spain is now the second largest source of FDI, contributing 16% of the total. Investors from France, the Netherlands and the United Kingdom also have a presence in the region.

Spanish firms are the key players in the services sector, especially in the telecoms industry and the banking system. The Spanish banks Santander Central Hispano (SCH) and Bilbao Vizcaya Argentaria (BBVA) own 52% of the assets of the region's top 10 transnational banks (ECLAC, 2005). In the telecoms industry, Telefónica of Spain's recent purchase of the United States mobile phone company BellSouth enabled the Spanish firm to maintain its lead position in the sector. In electric power and gas distribution, Endesa of Spain is among the leading foreign firms that occupy dominant positions in the Southern Cone, except in Brazil.

3. Efficiency-seeking investment

Efficiency-seeking investment has proven more difficult to attract in Latin America. Mexico and the Caribbean Basin form the only subregion to have received FDI seeking efficiency in goods production. Such investment in Mexico goes to the automotive, electronics and clothing industries and has been strengthened by the North American Free Trade Agreement (NAFTA). By contrast, the Caribbean Basin attracts this type of investment mainly in clothing and, to some extent, electronics. The Central American Free Trade Agreement (CAFTA) will not substantially alter that pattern. The Intel semiconductor assembly and testing plant in Costa Rica is an example of investment in electronics.

Although investment in this subregion has boosted its exports, it has produced little in the way of positive spillover in terms of technology transfer and absorption, production linkages, human resources training and local business development (ECLAC, 2004 p. 43). Costa Rica has been successful in attracting efficiency-seeking FDI in the service sector, whose exports have been driven by back-office and call centre services. This small country of 3.5 million inhabitants marketed itself on the basis of its political and economic stability, highly educated young people and proximity to the northern market.

V

Policies used to attract FDI in Latin America and the Caribbean

Over the past 15 years, the Latin American and Caribbean share in FDI inflows has waned, showing that, in practice, most of the countries' incentives policies were of limited effectiveness in attracting FDI in today's competitive market. To a lesser extent, the lack of success was also the result of a poor policy approach to FDI, since the governments were more concerned with short-term macroeconomic priorities than with long-term economic development. A large proportion of the FDI received in the region has come in the form of acquisitions of existing companies (Athukorala and Rajapatirana, 2003), sometimes as part of privatization programmes (ECLAC, 2004). Greenfield investment, which is the type that creates new plants, increases productive capacity and provides greater economic value, has been very limited.

Much has changed since Latin America was the developing region of choice for foreign investors. During the 1980s, a number of countries began to promote FDI by means of macroeconomic polices and industrial mechanisms, including low taxes, grants and loans for foreign investors, in some cases going so far as to extend monopoly rights (Blomström, 2001). Ever since, a market site's attractiveness has been about more than the availability of natural resources and open market policies (liberalization, privatization and deregulation of the economy), since investors have been able to find markets offering more benefits and lower costs and risks. Clearly, it was during this period that Latin America's pull as a market site began to weaken and its share in FDI inflows began a drastic decline that lasted until 2004.

Like in other world regions, FDI flows into Latin America have been largely confined to a small group of countries: Brazil, Mexico, Argentina and Chile. In 2003, Brazil received the highest percentage of FDI in Latin America, determined largely by its domestic market size and potential as a base for exports to other countries in the region.[5] The second largest recipient of FDI in Latin America is Mexico, whose competitiveness has been enhanced by trade agreements, principally NAFTA. Argentina has been the country hardest hit by the decline of FDI inflows to the region since 1999 (see figure 2). Although its economy has started to pick up again, Argentina is still far from regaining the levels of FDI seen before the financial crisis (UNCTAD, 2004). In 2003, Chile was one of the few countries in the world to increase its FDI share. Since 2001, FDI in Chile has benefited from the country's stable economy and dynamic business environment anchored in strong institutions. The drop in FDI recorded in 2000 reflected a return to more normal levels after exceptionally high inflows in 1999.

We have identified three factors that explain why the Latin American countries are currently facing difficulties in attracting FDI. First, in the era of globalization, natural resources alone are insufficient to create an attractive investment climate in the region. For over 100 years, Latin America received FDI mainly because of its natural resources (ECLAC, 2004). In the past, natural resource-seeking investors gravitated to places where raw materials and minerals were found. Today, investors still seek natural resources, but they also consider the availability of low-cost labour, a skilled workforce and quality physical infrastructure (Kinoshita and Campos, 2004). Another important reason why natural resources do not in themselves add up to an attractive investment climate is price volatility, since Latin America's natural resources are exported largely as raw materials, which does not generate value added for the economies (ECLAC, 2003).

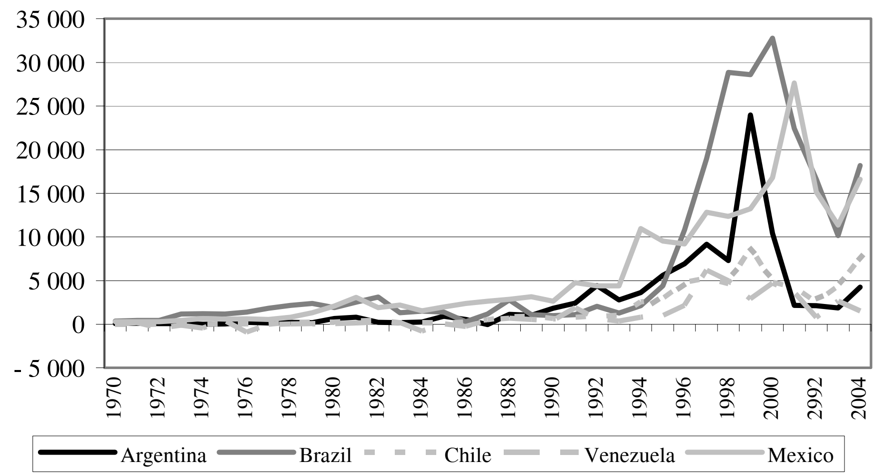
Second, serious failures have occurred in the promotion of efficiency-seeking investment. Efficiency-seeking investors focus on labour productivity, resource and input costs and the country's participation in regional integration frameworks (Dunning, 1988). In the 1990s, Latin America was concerned mainly with recovering from the decade before and neglected important aspects that have now become crucial determinants of FDI. While their competitors for FDI were pursuing growth-enabling macroeconomic policies, the Latin American countries employed tight monetary and fiscal policies that helped to hold down rates of economic growth and investment (UNCTAD, 2004, p. 620).

Education and training were high priorities for the "Asian Tigers" (Addison and Heshmati, 2003), whereas

FIGURE 2

Latin America: main recipients of FDI, 1970-2004

(Millions of dollars)



Source: UNCTAD (2005b).

[5] The main recipient of FDI in Brazil was the food and beverage industry, followed by telecoms services. The largest investors are from the Netherlands (45%) and the United States (17%), although Spanish, French and Mexican investors have also established a presence.

labour market training was largely absent from the FDI policies of most Latin American countries, despite the region's human capital potential: for example, adult literacy averages 88.6% in Latin America, not far from the average Asian rate of 90.3%, and Latin America has the developing world's highest score in the Human Development Index, at 0.777, compared with the average rate of 0.74 for the Asian countries (UNDP, 2004). By enhancing local human capital and modern infrastructure and improving other fundamentals for economic growth, a country is investing long term, since spillovers of foreign investment will feed into the domestic economy.

Third, the Latin American countries also failed to implement effective industrial policies as part of a long-term development framework. Generally speaking, Latin American countries have adopted a "the more the better" approach[6] to FDI, with a strong focus on the balance of payments or external financing (ECLAC, 2000). They have not, in general, targeted FDI promotion or aimed it at specific national development goals, such as improving international competitiveness, deepening industrialization, promoting technology transfer and management practices, and so forth. The Latin American countries have also exhibited a clear lack of promotion and linkages between programmes (Willem te Velde, 2001, p. 28), which accounts for the absence of positive spillovers. Linkages are essential for channelling knowledge and skills from foreign affiliates to domestic firms (Battat, Frank and Shen, 1996).

VI
The Irish model of FDI attraction

Ireland is a success story, with a history of steadily improving its locational advantages and competitiveness over time (it held fiftieth place in the mid-1990s)[7]

In 2001-2003 Ireland ranked fourth in the world as a recipient of FDI and its economic growth model has been hailed as an example of development. In the 1990s, Ireland was the best performing economy among the OECD countries (Barry, Bradley and Hannan, 1999), with one of the highest rates of per capita GDP in the world, low unemployment, stable economic and financial systems and a high standard of living. In 2005, Ireland ranked first in the quality of life index prepared by the Economist Intelligence Unit.[8] A number of explanations have been advanced for the Irish economy's recent success, but the general consensus is that FDI has been crucial to its economic prosperity (Barry, 1999; Willem te Velde, 2001; O'Connor, 2001; Ruane and Gorg, 2000).

The Irish renaissance is attributable to a combination of historical developments and strategic policies holistically applied by successive governments with a long-term vision of economic development.

1. Historical developments

One of the most important historical factors was the Great Famine, which instigated Ireland's long history of forced emigration. It has been acknowledged that Ireland's mass exodus during the first half of the nineteenth century left the task of building economic prosperity to future generations. The Irish population emigrated to countries that offered better economic prospects than their homeland (Barry, 1999, p. 25). Today, the Irish diaspora stands at 70 million, mostly residing in the United States, where 44 million claim Irish origins. Because of this, Ireland has always enjoyed special ties with the United States. Today, American technology firms have poured billions of dollars into Irish industries.

The second important historical development is the failure of trade protection policies employed in 1930-1960 in the context of the small Irish market. The Irish economy performed very poorly during this period, with an average growth rate of 1.67% (Ó Gráda and

[6] "The more the better" approach refers to the practice of attracting as much FDI as possible, while disregarding the quality of the investment to some extent.

[7] In the index prepared by UNCTAD on countries' performance as FDI recipients (UNCTAD, 2004 p.13).

[8] See *The Economist* (2005).

O'Rourke, 1996). The import substitution policies created an exclusively home-market oriented industry in which imports increased faster than exports, generating a balance-of-payments deficit. In view of the prosperity of other European countries, Ireland was obliged to move towards market-oriented policies. Its commitment to free trade was sealed with the Anglo-Irish Free Trade Agreement signed in 1966.

The third important development occurred in 1973, with Ireland's admission into the European Community (EC), known as the European Union (EU) since the entry into force of the Maastricht Treaty of 1992. Ireland's membership of the European Union has brought it great benefits in the form of trade relations and financial assistance. Since its entry, Ireland has received structural assistance through different programmes promoting economic and social cohesion.[9] Financial support from the European Union helped Ireland to modernize its infrastructure, which contributed greatly to increasing its appeal as a location for FDI. From the late 1970s to the early 1990s, net transfers from the EU to Ireland represented between 4% and 7% of Ireland's GDP. EU financial support underpinned massive investment in infrastructure, for instance, US$ 60 billion has been spent on modernizing telecoms infrastructure since 1982. The success of Ireland's economy will make the country a net contributor to the European Union in 2006.

2. Strategic policies

Ireland developed a strategic framework for national policy, encompassing industrial and macroeconomic policies on FDI, which has been crucial to its success in attracting FDI. Even more important, however, is the way it has used FDI as a method of economic growth. Willem te Velde's (2001) classification of industrial and macroeconomic policies allows us to identify the main strategic tools that Ireland has employed.

(a) *Industrial policies*

(i) *Long-term strategic focus.* In the 1960s, one of the most important decisions of policymakers was the setting of long-term economic development goals in the light of national priorities. Government policies focused on job creation in response to high unemployment and foreign investment was promoted as a generator of employment. In the absence of natural resources, the best thing Ireland could do to attract FDI was educate and train the labour market in the use of high technology. For years, successive Irish governments maintained this long-term strategic approach and increased educational investments in technology, expanded the university system and created vocationally and technologically oriented institutions and national institutes of higher education.

(ii) *Creation of an institutional framework for investment promotion.* Ireland's framework for investment promotion is an essential component of its success in attracting inward FDI. The Industrial Development Agency, known as IDA-Ireland, has advocated for the formulation and effective implementation of marketing policies. Enterprise Ireland was created to foster new company start-ups and build linkages between multinationals and local industry. More recently, the Science Foundation of Ireland (SFI) has been established to promote the new Irish brand "knowledge economy" (Enterprise Ireland, 2004).

(iii) *Competitive positioning.* Its young educated workforce has played a key role in Ireland's economic success. Ireland has Europe's highest percentage of under-25 population, at 37%, according to Eurostat, the EU statistical office. Government policies continue to support education, to which they allocate 13% of the budget. Around 90% of secondary students finish school at 18 years of age, with 54% going on to higher education and about 65% of students going into the technology and business fields, which is the highest proportion in the OECD (OECD, 2003).

(iv) *Targeting high-value added sectors.* Through a policy of sectoral targeting, Ireland was able to create a good climate for investment for three high-value added sectors: information technology, the pharmaceutical industry and internationally traded services. In the last 20 years, Ireland has become fertile ground for technology and is known as the computer centre of Europe.

(b) *Macroeconomic Policies*

(i) *Sound macroeconomic performance and prospects.* The Irish economy has proven remarkably resilient in the era of globalization. Inflation has remained low and currently stands at around 2.02% per year (CSO, 2005), which is the lowest among the OECD countries. Recently, the government budget and the balance of trade have been in substantial surplus and this underpinned the adoption of a strongly pro-growth fiscal policy (see table 3). A pro-active fiscal policy has been one of the keys to creating an attractive location for FDI. The provision of grants and subsidies

[9] See Barry, Bradley and Hannan (1999).

TABLE 3
Ireland: external trade
(Millions of dollars)

Year	Imports	Exports	Trade surplus
1988	12,970.10	15,623.90	2,653.90
1989	15,597.80	18,534.40	2,936.60
1990	15,832.10	18,203.90	2,371.80
1991	16,317.20	19,070.10	2,752.90
1992	16,753.90	21,260.20	4,506.30
1993	18,899.70	25,178.50	6,278.80
1994	21,945.40	28,890.90	6,945.50
1995	26,180.90	35,330.10	9,149.20
1996	28,479.50	38,608.90	10,129.40
1997	32,863.50	44,868.00	12,004.50
1998	39,715.00	57,321.80	17,606.80
1999	44,327.10	66,956.20	22,629.10
2000	55,908.80	83,888.90	27,980.10
2001	57,384.20	92,689.90	35,305.70
2002	55,628.10	93,675.20	38,047.10
2003	47,864.60	82,076.10	34,211.50
2004	50,565.50	84,160.10	33,594.60

Source: CSO (2005).

and strong investment in promotion, together with the regime of low corporate taxes, have undoubtedly contributed greatly to good economic performance.

(ii) *Open market economy.* The failure of protectionist policies led to a broad national consensus regarding the direction of economic and industrial policy. Ireland has never been divided on this issue. There was no debate between the political left and right on the opening up of the economy, as both main political parties are conservative right of centre, with the differences between them not related to economic policy but rooted in the civil war of the 1920s.

(iii) *Creating a propitious economic environment.* Adding to the availability of a skilled labour force and infrastructure, Ireland devised fiscal and financial incentive schemes. Financial incentives are extended in the form of investment and training grants, low-interest loans, and so forth. Fiscal incentives are framed within the low corporate tax system, which is acknowledged being at the core of Ireland's appeal for multinationals (Ruane and Gorg, 2002, p. 8). The tax system in Ireland remained unchanged for a long time. From 1954 to 1980, a zero tax rate applied to the profits of manufacturing industries. From 1980 on, a 10% applied to manufacturing profits, with firms that qualified for this rate in July 1998 entitled to pay tax at 10% until 2010. For newcomers (since 2003), a 12.5% tax rate applies to corporate trading income.

(c) *Other factors: the national consensus*

Since the late 1980s, Ireland has adopted a series of national agreements on wages and taxes as part of the Programme for National Recovery. The economic crisis in Ireland in the mid-1980s spurred discussions between government, employers and trade union leaders. The main negotiations, in which leading employers and labour interests were represented, gave rise to the Social Partnership Agreement, which was signed by the government, employers and trade unions. This tripartite agreement, which was renegotiable every three years, helped to moderate wage demands and lower inflation.

Underpinning all of this was a very conscious effort to ensure policy coordination at national and local levels. The acid test for any new policy initiative was an assessment of whether it would enhance or impede investment in Ireland, be the investors foreign or indigenous. This mindset was crucially important, since well-intentioned policy initiatives that were found to have potential for undesired or unintended negative effects on investment could then be rejected or modified accordingly. This holistic approach to development was very reassuring for foreign investors, as an indication of the importance that successive Irish governments attributed to their investments.

3. The institutional framework of investment promotion in Ireland

The investment promotion framework deserves the most credit for Ireland's successful drive to attract FDI, create linkages between foreign and local industry and upgrade its competitive advantages. The Irish model of investment promotion has encompassed activities ranging from public image campaigns, marketing strategies, development of financial and fiscal incentives and services for potential investors to fostering links between inward investors and the domestic industry. Recently, Ireland has focused on creating a new brand image as a knowledge economy. Three institutions have been established to this end: the Industrial Development Agency, in 1969; Enterprise Ireland, in 1993; and the Science Foundation of Ireland, in 2003.

(a) *Industrial Development Agency (IDA-Ireland)*

IDA-Ireland was created to carry out investment promotion activities. Its primary objective was to secure new investment from overseas for manufacturing and international services, in order to create jobs. Since its establishment, IDA-Ireland has played a key role in supporting and administering most of Ireland's investment promotion programmes. Although the agency's primary objective has become no less important over the years, the maximization of economic and social benefits deriving from foreign investment has also become central to its policy strategy.

(i) *Sectoral targeting strategy*. The development of strategies to attract high quality foreign investment has always been high on IDA-Ireland's agenda. The agency's intervention was instrumental in the investment decision of the first TNC to site a plant in Ireland, Digital Equipment Corporation. By 2004, more than 1,022 TNCs had located in Ireland, employing 128,946 workers. As shown in table 4, most of these companies are from the United States (478), Germany (140) and the United Kingdom (116), but FDI in Ireland comes from numerous sources.

TNCs are present in a wide range of activities, but most of the FDI in Ireland has gone to the pharmaceutical and health care sectors and to international financial services. Across all the FDI inflows to Europe, Ireland has attracted 41% of software projects, 31% of pharmaceutical and medical technology and 34% of pan-European shared services (IDA–Ireland, 2003 p. 5). Ireland's large pool of highly skilled labour has matched the requirements of FDI in high-technology projects. The presence of TNCs has significantly contributed to the standard of living in Ireland. For example, in 2003, TNCs paid an average annual salary of 37,000 (IDA–Ireland, 2003 p. 4).

(ii) Marketing. Through its network of overseas offices, IDA–Ireland markets the country's advantages for high-technology TNCs by emphasizing the competitiveness and stability of the economy, the skills base of its highly educated workforce, the favourable tax regime and the available financial incentives. The capability and experience of IDA–Ireland in successfully attracting foreign TNCs are widely recognized.[10]

As described in MacSharry and White (2000),[11] the agency first began to target such sectors as biotechnology, computer software, electronics and healthcare in the early 1980s. It identified key firms within these sectors, established contacts and developed long-term relationships –lasting up to 10 years in some cases, including IBM and Intel– before the firms committed to establishing export platforms in Europe.

TABLE 4

Ireland: foreign investment, 2004

Country of origin	Number of companies	Total employment
Australia	6	145
Austria	7	305
Belgium	13	954
Bermuda	9	420
Canada	16	960
China	1	6
Denmark	8	1,814
Finland	4	399
France	41	2,226
Germany	140	11,158
Greece	1	48
Israel	1	63
Italy	23	560
Japan	32	2,639
Liechtenstein	1	10
Luxembourg	2	160
Netherlands	41	2,933
Norway	1	20
Other non-European	3	84
Republic of Korea	6	205
South Africa	2	31
Spain	3	14
Sweden	14	2,230
Switzerland	25	2,645
Taiwan Province of China	1	7
Turkey	2	5
United Kingdom	116	6,824
United States	478	90,230
Total	1,022	128,946

Source: Annual Employment Survey (Forfas, 2004).

In 1974-1975, indigenous firms provided two-thirds of all manufacturing jobs in Ireland and TNCs employed the remainder. By 1998-1999, however, TNCs accounted for almost half of all manufacturing jobs.

(iii) *Investing in promotion*. IDA–Ireland has invested heavily in promotion over the years, thanks to its considerable budget allocations. The average cost per job sustained in supported companies in 1996-2002 was estimated at 15,897 euros. According to the *IDA Annual Report 2003*, expenditure that year amounted to 155 million euros, of which 62% was spent on grants to industry, 22% on promotion and administration, and 6% on land and site development (IDA–Ireland, 2003). On the other hand, the Irish government collected a total of 2.6 billion euros in corporation tax from the FDI sector alone in 2003 and the total number of full time jobs created stood at 128,993.

(iv) *Facilitating information*. Since its establishment, IDA–Ireland has expanded rapidly. Today

[10] See, for example, Loewendahl (2001).

[11] This publication is co-authored by one of IDA–Ireland's former managing directors.

it has a staff of 280, including 40 officers working in 13 overseas offices, who provide foreign investors with quality information and support network facilities in order to minimize bureaucratic costs.

(b) *Enterprise Ireland*

Enterprise Ireland was created to provide business support to indigenous Irish enterprises. This goal has been successfully achieved through promoting innovation and productivity, supporting the creation of new companies, encouraging enterprise development and providing business training. These are the key elements that have provided Irish companies with the means to compete successfully in international markets.

(i) *Creating linkages.* Since its establishment, Enterprise Ireland has played a significant and effective role in linking up foreign affiliates' sourcing requirements and the production profile of local suppliers. Enterprise Ireland has also encouraged the establishment of venture capital funds that have to a large extent transformed the domestic technology industry. Two prime examples are Iona Technologies and Parthus Technologies. The services that Enterprise Ireland has developed over the years are delivered through a network of 13 offices in Ireland and 34 overseas, from which it serves some 500 to 600 Irish firms at any given time. As part of its promotional activities, Enterprise Ireland proactively identifies international buyers through sales meetings, missions at home and abroad and trade fairs.

(ii) *Targeting new high-level industry.* In 2002, Enterprise Ireland launched the Building Biotech Business Strategy to promote new industry. Biotechnology was identified as an industry primed for growth that would fuel the Irish economy in years to come. Enterprise Ireland's strategy is designed to propel Irish industry toward becoming a biotech hub. The agency aims to create a new generation of companies in this industry, in order to keep Ireland on the technology map. For success in the biotechnology industry, the key factors identified are strong research-oriented universities, an educated workforce and State and corporate support (Enterprise Ireland, 2004). Enterprise Ireland has concluded that cutting-edge university research appears to be the most crucial asset and has therefore focused on supporting university research that is most likely to generate new knowledge, as the basis for new technologies and competitive enterprises.

(c) *Science Foundation Ireland*

Science Foundation Ireland (SFI) was created in 2003 to maintain competitiveness in the global economy. The Foundation was entrusted with the promotion of scientific research and industry innovation in order to foster Ireland's image as a knowledge economy. Knowledge has become the key message in FDI promotion, under the banner "Ireland, knowledge is in our nature". The role of SFI is to establish Ireland as a centre of research excellence in scientific areas that are strategically linked to economic development.

Policymakers view SFI as the agency that will secure Ireland's position at the fore of scientific development. In 2000-2006, SFI will provide 646 million euros to academic researchers, particularly in the areas of biotechnology and communications technology. SFI is seeking to attract scientists and engineers from around the world to develop a knowledge-based economy in Ireland.

VII

Learning from the Irish model and moving forward

The competitiveness of the Asian countries threatens the Latin American countries' position in the global market, not only because the region has failed to attract quality investment but also because it has neglected relevant factors that could have made FDI an instrument for growth. The challenge for the Latin American countries now is to move on from capturing predominantly resource– and market-seeking investment towards successful attraction of the efficiency– and technological asset-seeking varieties. Although not all aspects of the Irish model are applicable to Latin America, a number of important aspects are to be considered.

1. Setting long-term economic development goals

All countries need a long-term plan for economic development that includes FDI as a driver of economic growth. It has taken Ireland about 30 years to build up a competitive and advantageous market site for FDI. In the mid-1990s, Ireland ranked fiftieth in market performance for FDI. Today it ranks fourth among all the countries (UNCTAD, 2004 p. 13) and was positioned seventh in terms of inbound FDI projects in the first half of 2005 (OCO Consulting, 2005).

2. Identifying comparative advantages

Ireland's model is extraordinary in that a small country with little indigenous resources has grown its competitive advantages through effective industrial policies and FDI advocacy. Ireland has invested heavily in human infrastructure (Durkan, FitzGerald and Harmon; 1999). Ireland's competitive advantage lies in its young, well-educated population. The availability of a highly educated workforce trained in advanced technology not only helped to attract FDI, but also raises the quality of the investment secured (Lall, 1997).

Latin America's competitiveness, by contrast, has been built up around its comparative advantages in natural resources and cheap labour, but the fact remains that the Latin American labour force is not as specialized or highly trained as that of its competitors. For instance, educational level and workforce training had much to do with successful promotion of FDI on the part of China, Malaysia, Singapore and Taiwan Province of China (Addison and Heshmati, 2003). Latin America must invest in human capital if it is to make the shift from resource-seeking to efficiency-seeking investment. A pool of skilled labour is not only a determinant of FDI in an economy but also a necessary part of its ability to absorb the spillover effects (Willem te Velde, 2001).

Porter (1998, p. 7) has argued that, "The enduring competitive advantages in a global economy lie increasingly in local things such as knowledge, relationships, motivation that distant rivals can't match."

Latin America's location should enhance its comparative competitiveness. Although distances have become less important with globalization, a country's location is still fundamental in an era of global competition (Porter, 2000).

3. Promoting comparative advantages effectively

Ireland's comparative advantages alone would not have sufficed to secure quality FDI inflows without IDA–Ireland's promotion of its image as an attractive market site. The approach pioneered by IDA–Ireland now heads the list of effective models for investment promotional agencies (IPAs) (Morisset and Andrews-Johnson, 2005). In recent years, the establishment of an IPA has been an important part of governments' development strategies in Latin America and elsewhere (Morisset, 2003), yet few have been successful.

The following are important elements of Ireland's IPA that could be applied in Latin America.

(i) The provision of a one-stop-shop system for investors is one of the main recommendations for any IPA. Using this approach, IDA–Ireland provides quality information and support networks that effectively save foreign investors time and money (Ruane and Gorg, 2000. p. 6). IDA–Ireland staff make it their business to know the key decision makers in other government departments and local authorities. With this network of contacts they are well positioned to guide investors through the procedures for obtaining the permits and approvals Irish law requires.

(ii) The establishment of a single government agency outside the civil service, together with the one-stop-shop scheme, has been crucial to IDA–Ireland's successful promotion work. The fact that the agency is operated independently, although owned by and accountable to the Government, increases its flexibility and enhances its credibility among investors (Loewendahl, 2001, p. 8).

(iii) Ireland has an aggressive investment agency. Through its network of overseas offices, IDA–Ireland has marketed the country as an attractive location for high-tech firms by spotlighting the competitiveness and stability of its economy, the favourable tax regime, the skills base of Ireland's highly educated workforce, duty-free access to the EU markets and the financial incentives on offer. IDA–Ireland's investment generation activities have also included targeted telephone calls, presentations and the provision of research to electronic and pharmaceutical companies in the United States, Europe and Japan (Willem te Velde, 2001, p. 37).

(iv) IDA–Ireland has also received substantial government support for promoting the country as a market site for FDI. Empirical findings point to a positive correlation between the effectiveness of a promotion agency and the amount of money spent on promotion.

IDA–Ireland has provided financial support in the form of grants, subsidies and training. The adoption of a similar practice in Latin America should be accompanied by oversight to avoid potential for corruption (Loewendahl, 2001, p. 17).

(v) The establishment of the National Linkage Programme in Ireland improved the agency's promotional skills and has efficiently created linkages between local and foreign industry. While IDA–Ireland has played an efficient promotional role in policy advocacy, Enterprise Ireland has fostered and promoted indigenous Irish industry and foreign investment. Building links between multinationals and the local industry has also contributed to the success of spillover and, hence, economic growth. One of the most effective ways to generate positive spillovers in Latin America would be to create linkages.

(vi) In order to promote its competitive advantages effectively, Ireland had to target specific sectors and adopt a future perspective. The most recent FDI-oriented industrial policy measure was the creation of Science Foundation Ireland and the latest strategy in competitiveness-building has been to provide university training in IT and biotechnology for the labour force.

4. Creating an attractive economic environment

Effective promotion is important in order to attract FDI. Promotion can be counterproductive in a country that offers a poor investment climate, however (Morisset, 2003, p. 18). The trade liberalization, privatization and deregulation carried out in Latin America since the 1980s have proven to be insufficient. Clearly, further stimulation is required to create a stable and an attractive economic environment for FDI. The factors that helped create an attractive environment for FDI in Ireland included:

(i) Economic stability, clear macroeconomic policies and the establishment of a sophisticated financial system.
(ii) Ireland's system of low corporate tax is recognizably one of its most important incentives for inward investment.
(iii) Access to third country markets.
(iv) The corporate environment.
(v) The quality of life.

VIII

Conclusions and recommendations

Attracting foreign investment has become a new means of achieving economic growth and poverty reduction for many countries. It is a futile endeavour, however, to attract FDI in the absence of the necessary conditions for economic development. The creation of a competitive market site requires efforts in many areas, but for FDI to be an instrument of economic growth it must be approached via holistic policies framed within a national economic development plan based on long-term development goals. In Latin America, the assumption that FDI would contribute positively to the economy and generate spillovers into local industry has not been borne out. The Irish experience shows the importance of effective industrial and macroeconomic policies and a technically sophisticated promotional framework in order to secure FDI that can feed into national economic development.

Much of the FDI received by the Latin American countries in recent years has represented the acquisition of existing companies, sometimes as part of privatization programmes. Greenfield investment must be the next target, in order to create new plants, increase productive capacity and expand economic value. Such investments are usually seen as having a stronger direct impact on national development. Just as Ireland targeted United States companies because of historical, cultural and linguistic links, Latin American countries should approach European nations whose heritage they share. European investors are increasingly important in the FDI market and Spain is the leading investor in the region today. Latin America should also consider Asian countries which are initiating or deepening foreign investment processes (such as China of the Republic of Korea, respectively).

Given how effective Ireland's strategic framework for promoting quality FDI has proven to be, Latin America would do well to devote energetic efforts to designing an investment promotion system.

Investment agencies should also coordinate and build linkages between FDI and local industry. Lack of linkages has been one of the main impediments to the absorption of spillover from FDI in Latin America. It is also important to invest more in education and training, since the traditional determinants of FDI have become less influential and investment in human capital seems to be the crucial factor today. If Latin America competes for investment solely on the basis of its natural resources and in the confines of its local markets, its position in the international market for FDI will be further weakened.

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The slow comeback of industrial policies in Latin America and the Caribbean

Wilson Peres

The core of a policy for accelerating economic growth is a combination of knowledge accumulation and diversification of the productive structure. These two dimensions are the focus of the present article, which examines industrial policy experiences during the import substitution industrialization period; highlights the policies currently being applied in Latin America and the Caribbean and offers a typology of the strategies underlying them; presents the main lines of action and policy instruments; and analyses issues of policy implementation and impact. The thesis is that, while policymaking capabilities have improved, a great deal of work is still needed on implementation and on the development of effective impact evaluation methodologies. Proper evaluation will show whether industrial policies have a role to play in the region.

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I
Introduction

This study sets out from the hypothesis that policies to create new production sectors or modernize mature ones are needed in Latin America and the Caribbean in order to boost development, subject to the constraints represented by the size, existing development level and productive structure of the different national economies.[1] By improving the product mix and the vector of international specialization, diversification of the productive structure has a vital role to play in closing the productivity gap between these countries and those at the international technology frontier and thus in accelerating overall productivity growth in open economies. Such diversification results in better domestic linkages, strengthening the positive impact of economic growth on overall productivity (Cimoli, Correa and Primi, 2003).

Policies to strengthen individual sectors can increase the density and complexity of a national productive structure, and these in turn are positively correlated with the stability of a country's growth rates and the speed and flexibility with which it responds to external shocks (Castaldi, 2003). The effect of productive complexity is to create internal counterweights to the transmission of shocks, thus generating automatic stabilizers. Specialization with a higher knowledge content and diversification are both important to allow full advantage to be taken of the growing returns to scale implicit in technical progress, leading directly to virtuous cycles of cumulative causality (Young, 1928; Stigler, 1951; Kaldor, 1966).

In summary, the key to any policy for accelerating productivity growth in the long term has to be a combination of knowledge accumulation and diversification of the productive structure. The first creates the opportunities; the second means that they can be capitalized upon. Both dimensions are dealt with in this study, which is organized into five sections. Following this introductory section, which reviews the broad outlines of industrial policy developments during the import substitution industrialization period, section II examines current policy practices in the region and offers a typology of the strategies underlying them. Section III presents the main lines of action and policy instruments, while section IV analyses policy implementation and impact evaluation issues. Section V, lastly, presents some conclusions.

Policies to create new sectors were the centrepiece of industrial policy in the import substitution model;[2] they are generally defined now as policies that seek to alter the goods and services production vector (Chang, 1994; Melo, 2001), which necessarily entails the creation of new activities. The goal of these policies was to take advantage of growth in domestic demand, investment demand in particular, to complete the industrial fabric of the countries, considering that this growth would otherwise have translated into rising imports, with all the external constraints these imply. During the 1970s, there was a growing perception that the effects of investment fell into two parts: on the one hand, the installation of productive capacity, with positive effects on aggregate supply; on the other, the concomitant demand for capital goods which, for lack of the right kind of domestic supply, increased import demand and thereby negated the beneficial spillover effects for the rest of the productive structure. At that time, the concepts of industrial policy, policy for the manufacturing sector and incentive policies for capital goods production were closely linked.

The main instrument of industrial policy was a combination of trade protection, promotion of direct investment (often by the State or from abroad), and financing provided by national development banks. The leading examples in the 1970s, before the rupture produced by the external debt crisis, were the second

[1] This study was prepared as part of the "Fomento al desarrollo productivo" project, in the framework of the ECLAC/GTZ programme "Modernization of the State, productive development and sustainable use of natural resources", and was presented at the second meeting of the industrial policy task force (Rio de Janeiro, March 2005) of the Initiative for Policy Dialogue (IPD). The author is particularly grateful for the comments of Antonio Barros de Castro (the presentation commentator), Alice Amsden, Mario Cimoli, Giovanni Dosi, Bernardo Kosacoff, Yevgeny Kuznetsov, Richard Nelson, Gabriel Palma and Gabriel Porcile. Parts of this paper were published in ECLAC (2004a, chapter 8).

[2] In this document, the terms "industry" and "industrial" are used in a broad sense, i.e., they include not just manufacturing industry but also non-manufacturing sectors such as agriculture and mining.

Plano Nacional do Desenvolvimento (National Development Plan) in Brazil and the Programa Nacional de Fomento Industrial, 1979-1982 (National Programme for Industrial Development, 1979-1982) in Mexico, which was in operation during the boom that accompanied the growth of the country's oil export platform.

Industrial policies were used to organize domestic supply growth and provide a focus for planning or programming in relation to the productive structure. Three interrelated factors strengthened this organizing role: (i) public-sector support mechanisms were organized at the sectoral or even subsectoral level;[3] (ii) private-sector interests were also organized in sectoral chambers or associations, which were the main defenders of the trade protection system; and (iii) international trade negotiations (for example, within the framework of the Latin American Integration Association (LAIA), the Central American Common Market (CACM), the Caribbean Community (CARICOM) or the Andean Pact) yielded negative or positive lists of sectoral preferences. Industrial policies concentrated on the agricultural and manufacturing sectors, although the preponderance of the latter was such that, as mentioned earlier, the concepts of sectoral policy and policy for the manufacturing sector tended to be conflated.

After playing this central role, industrial policies gradually lost legitimacy over the course of the 1980s, to the extent that they were virtually absent from the new economic model ushered in by structural reforms, at least in its strictest version. Policies of this kind lost credibility for a number of reasons. The main ones were: the privatization or closure of public-sector enterprises that invested directly in new sectors, since the new vision for the State gave it only a subsidiary role in the economic dynamic; the need to balance the public finances by doing away with subsidies, particularly those of a fiscal nature and the subsidy components of lending operations; and the perception, sometimes a questionable one, that many investments had involved poor planning, faulty project management and corruption, and indeed that some projects were no more than pointless "white elephants". This loss of legitimacy did not occur everywhere in the world. Thus, for example, in a number of East and South-East Asian countries, active policies targeted on individual sectors or even companies remained in force until well into the 1990s, when they became less common as, albeit at different paces, these countries gradually entered the free market mainstream and the new international trading regime.[4]

Whatever the merits of the economic arguments against industrial policy, opposition to the new economic model among the political supporters of this policy served to consolidate the "developmentalists versus neoliberals" stereotype. Supporters of structural reform combated those who opposed it by stressing the argument that sectoral industrial policies were to blame for distorting the allocation of resources and creating the fiscal imbalances that underlay inflation. A growing number of governments in the region also took a critical stance towards industrial policy.[5] This extreme position was not always matched by the reality, however; even some governments that were strong reformers, such as those of Menem in Argentina, Collor de Melo in Brazil and Salinas de Gortari in Mexico, kept some sectoral policies, particularly for the automotive industry.

[3] For example, ministries of industry, agriculture, mining and others and, within these, departments for food, metallurgy, chemicals, capital goods, etc.

[4] The debate about the effect of industrial policies in Asia is wide-ranging and still inconclusive, although the 1997 crisis meant that attention shifted from industrial policies to other issues where that region was concerned. For positions favourable to these policies, see Amsden (1989), Rodrik (1995) and Wade (1990), and for critical positions see World Bank (1993), Krugman (1994) and, more recently, Noland and Pack (2002). Again, the agricultural policies of the industrialized countries show that sectoral policies are far from being just a quirk of a few underdeveloped countries in the past.

[5] In the early 1990s, it was common to hear from top macroeconomic policy officials the dictum that "the best industrial policy is no industrial policy". Simple as it was, this maxim summed up their attitude quite well.

II

Industrial policy practice and strategy

1. The experience of the region

Much of what the region is currently doing in industrial policy is covered by the phrase "competitiveness policies" (Peres, 1997).[6] The policies now followed in the region can be divided into four main groups:

(i) Policies that are a continuation of those developed during the import substitution industrialization period and that aim to expand and deepen a particular sector by creating new segments within it and applying some combination of trade protection and fiscal and financial incentives. Prominent examples of these policies are the automotive industry regimes created in Mercosur to organize and expand investment by producers of cars and car parts (ECLAC, 2004b, boxes III.3 and III.4). In many of the region's countries, there have been sporadic measures to support sensitive (and uncompetitive) sectors such as textiles, wearing apparel, footwear, electronic products and toys, and a whole range of agricultural products and mining activities, with details varying by country; this support has been much more stable than incentives for manufacturing. Even in sectors with revealed comparative advantages, like some important segments of the agricultural sector, it has often been necessary to introduce schemes to help them cope with short-term crises[7] or longer-term challenges resulting from a relative loss of competitiveness.[8]

In the agriculture sector, a number of countries (including those of Central America, Brazil, Colombia and the Dominican Republic) have continued to intervene directly in markets for staple grains (wheat, maize, rice). Increasingly, however, direct market intervention (by means of guarantee prices, for example) and subsidized credit are being replaced by programmes aimed at small producers, who are the most affected by trade liberalization, and by horizontal instruments including, among others, spending on animal and plant health programmes, irrigation and land title schemes (FAO, 2001 and ECLAC, 2003). Growing importance is also being given to territorial or local programmes, such as fiscal incentives in poor regions or integrated rural development schemes, so called because they combine infrastructure investment with training and technical assistance in relatively disadvantaged rural areas.

(ii) Policies targeted on sectors, which have now evolved into economy-wide policies. This is the case with policies for the electronics and information technology industry, which began as hardware import substitution policies and were then used to support software development, and which have now been integrated into strategies to develop information and communication technologies (ICTs) and even create "information societies" in Latin America and the Caribbean.[9] Because there is widespread potential for scope and network economies and for complementarity between different activities, these policies need to be transversal, transcending sectoral or institutional boundaries that are in any case tending to blur.

(iii) Policies centred on highly concentrated sectors and based on scale and network economies (electricity, telecommunications, oil and natural gas). The aim of policies in these sectors, almost all of which have been

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[6] The impact of economic reforms and macroeconomic policy on the industrial dynamic is beyond the scope of this study. It should be noted, however, that reforms such as trade liberalization and privatization, and monetary and exchange-rate policies too, have often had a strong influence on this dynamic, leading to their being considered veritable "implicit industrial policies". Such implicit policies have often been decided on without adequate knowledge of the region's microeconomy, i.e., of the specific dynamics of its businesses and markets (see Stallings and Peres, 2000).

[7] For example, the tax exemptions for meat producers during the foot-and-mouth crises in Uruguay, discussed by Scarone (2003). Again, 2003 data for Brazil show significant support for a number of sectors, including electricity (US$ 1 billion in credit lines from the Banco Nacional de Desenvolvimento Econômico y Social, BNDES, to capitalize 24 distribution companies), information technology (US$ 500 million worth of reductions in the industrialized products tax, or IPI), automobiles (US$ 120 million worth of IPI reductions for small and medium-sized vehicles) and household electrical appliances (US$ 70 million in credit lines). See Balbi (2003).

[8] As has happened with "sun and sand" tourism in much of the English-speaking Caribbean (Hendrickson, 2003), or in Mexico with agricultural conversion programmes to introduce crops with greater potential, value-added and market opportunities, as an objective of the Alianza para el Campo (Rural Alliance) (Villagómez, 2003).

[9] See ECLAC (2005) for a general approach to the subject; for national analyses, see Bonelli and Motta Veiga (2003) on Brazil, Scarone (2003) on Uruguay, and Henry (2003) on the Caribbean.

settled upon since privatization, has been to develop efficient frameworks of regulation, and this has meant creating and building up regulatory agencies, adapting the legal framework and striving to harness the growth of investment in these sectors to the supply capacity of domestic suppliers, a linkage that varies in strength from one country to another.[10] Brazil has gone so far as to set up "technology funds" to support scientific and technological development programmes in each of the sectors concerned, funded from the royalties paid by companies.

(iv) Policies to support clusters, particularly those composed of small and medium-sized enterprises, or of a large number of such enterprises under the leadership of big firms. This approach has found increasing acceptance in the Andean and Central American countries and, like other industrial policies, its purpose has been more to increase the competitiveness of existing sectors than to create new activities. In countries such as Mexico and Brazil, vigorous measures have been taken to encourage these clusters at the subnational level. This is illustrated in the case of Mexico by the support given to the footwear sector in Guanajuato and the electronics sector in Jalisco (Unger, 2003; Dussel Peters, 1999), and in the case of Brazil by the actions of the Brazilian Micro and Small Business Support Service (SEBRAE) throughout the country as part of the project to develop "local production arrangements".[11] This type of policy enjoys great legitimacy, even among international financial organizations, and this has made it more acceptable to governments and even led to some measures being described as "support for clusters" when the activities they assist do not qualify, strictly speaking, either as a production chain or as a geographical cluster.[12]

2. A typology of national strategies

Following a resurgence of interest in active microeconomic and sectoral policies in the mid-1990s, three approaches to competitiveness policy were shaped. Some countries, chiefly Brazil, Mexico and those of the English-speaking Caribbean, produced policy documents specifically oriented towards the industrial sector and its linkages with technological development and international trade.[13] These documents were not so much industrial plans or programmes, strictly speaking, as shared working agendas for government and the private sector, and this led their critics to accuse them of being "programmes without goals" and even "without resources".

In the Andean and Central American countries, the main thrust of policy was to raise the competitiveness of the economy as a whole without giving any particular priority to the industrial sector. National competitiveness strategies were based on the cluster analysis methodology, and clusters were referred to under a variety of names, such as *"aglomeraciones industriales"*, *"arreglos productivos"* and *"conglomerados productivos"*.[14] In practice, these approaches led to the negotiation and implementation of sectoral agreements, generally spanning value chains, between private-sector actors and government, with the latter acting as a catalyst or facilitator.

Argentina, Chile and Uruguay, lastly, did not work on the basis of industrial policies or national competitiveness strategies. Preference was given instead to what are known as horizontal policies,[15] which were

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[10] See Sergeant, Racha and James (2003) on Trinidad and Tobago.

[11] In Portuguese, *arranjos produtivos locais* (APL). The characteristic of these arrangements is that they cover a significant number of businesses whose operations centre on a production activity that is dominant in a particular territory and which share forms of cooperation and governance mechanisms. APL support measures are local, which is consistent with the Brazilian experience of state policies with a strong sectoral component. Examples of these policies are support programmes for the automotive industry (through subsidies and even capital investments by some state governments), the electrical, electronics and information technology industry, textiles, wearing apparel and footwear. See Bonelli and Motta Veiga (2003).

[12] See Velasco (2003) regarding sectoral agreements in Colombia.

[13] Pérez Caltendey (2003) highlights the importance of sectoral incentives in Caribbean economies, particularly among the member countries of the Organization of Eastern Caribbean States, Barbados and, most particularly, Guyana, which has the widest range of incentives in the region. These incentives are basically designed for the manufacturing and service sectors, particularly hotels and tourism (Hendrickson, 2003).

[14] This approach was based on Porter (1990) and given effect in the work done by the Monitor Company in the Andean countries in the early 1990s and in the project "Central America in the 21st century: an agenda for competitiveness and sustainable development", coordinated by INCAE/Latin American Centre for Competitiveness and Sustainable Development (CLADS) in the mid-1990s.

[15] The expression "neutral or horizontal policies", in widespread use across the region, conceals the fact that any policy will ultimately favour certain sectors over others. This happens because these policies seek to raise the efficiency of production factor markets, which are used in different proportions by the different sectors or products. In some cases, policies that are presented as neutral to give them greater legitimacy are oriented from the outset towards specific sectors. This is usually the case with technological development policies.

supposed to be non-discriminating between sectors and to be implemented by means of incentives to company demand, by contrast with the supply subsidies that characterized the earlier model. When problems with a clear sectoral dimension arose, horizontal policies instruments would be brought to bear on solving these, without these policies being thereby deemed to have lost their essentially neutral character. It was in Chile that this type of intervention was conceptualized and implemented most forcefully, although the country long continued to provide direct subsidies to the forestry and mining sectors and to export activities (Moguillansky, 2000).

In the early 2000s, by contrast with what has been happening in other development policy areas, there has been no convergence in the positions of the Latin American and Caribbean countries where sectoral policies are concerned. While in some the official stance is strongly against these policies (although sectoral support is provided ad hoc), in others they are recognized as a valid way of raising the competitiveness of activities that have the potential to penetrate external markets or that face strong competition from exports. There are some double standards with these policies: countries that deny their utility, particularly when it comes to support for manufacturing, use them openly and without any attempt at justification in numerous areas of agriculture and services (tourism, for example).

Taking the historical analysis of policymaking that has been presented here as a basis, the region's countries can be classified or ordered by three variables: the purpose of the intervention, its frequency or intensity, and the level of coordination between the policy implementation measures taken as part of a broader strategy.

Going by the purpose of intervention, three types of countries can be distinguished, as noted above: (i) those that have maintained or even revived sectoral policies, (ii) those where sectoral policies essentially concern clusters, and (iii) those that have not taken either of these two approaches and only accept the use of policies considered to be horizontal, although these will sometimes be concentrated on a specific sector.

Horizontal policies are widely accepted in all three types of countries. What distinguishes the first two types are the policies they apply in addition to horizontal ones. Table 1 highlights the use of development bank lending and fiscal incentives oriented towards specific sectors.[16]

[16] The amount of implicit subsidy in lending operations and fiscal incentives cannot be determined from the information available.

In seven of the region's countries (Argentina, Brazil, Colombia, Costa Rica, El Salvador, Honduras and Mexico), public-sector development banks carry out sector-oriented lending, while in 18 countries fiscal incentives have been established for the benefit of specific sectors. Only in Colombia, Guatemala, Haiti, Honduras, Paraguay and Suriname do no such incentives exist. An even commoner type of incentive is the existence of special rules that favour the creation of free-trade export zones or *maquila* industries.

Taken together, this information immediately reveals one difference from the practices associated with the earlier model. Whereas preference was given then to manufacturing, this is now one of the sectors with the least weight. The activities most favoured have been tourism, commodity sectors such as oil, mining and forestry, and miscellaneous services (ranging from infrastructure to film-making). The importance of agriculture-oriented policies varies appreciably among the region's countries if it is measured by the public funds spent on implementing them (including productive development programmes, rural infrastructure investments and social spending in rural areas).[17] Public-sector development banks, meanwhile, make an important contribution to the financing of this sector in countries such as Argentina, Brazil, Costa Rica, the Dominican Republic and Mexico (Acevedo, 2002). Generally speaking, lending is carried out on near-market terms and interest rate subsidies are retained in programmes to support small-scale farming.

The above description needs to be modified somewhat in the light of the lending portfolios of the six development banks in five of the region's countries. Industry still receives about half of all loans from the Banco Nacional de Desenvolvimento Econômico e Social (BNDES) in Brazil, the Banco Nacional de Comercio Exterior (BANCOMEXT) in Mexico and the Banco de Comercio Exterior de Colombia (BANCOLDEX), while it accounts for about 25% of the total portfolio of the Corporación Financiera de Desarrollo (COFIDE) in Peru and less than 15% of the portfolios of the Banco Nacional de Costa Rica (BNCR) and Mexico's Nacional Financiera (NAFIN). Given that BANCOLDEX and BANCOMEXT lending is for foreign trade financing, of the six institutions only BNDES seems to

[17] In Chile and Mexico, annual expenditure per producer totalled US$ 900 in 2000, whereas in Bolivia it was less than US$ 50. That same year, agricultural spending as a proportion of the sector's GDP was 35% in Mexico, 21% in Chile and just over 5% in Bolivia (Kerrigan, 2001).

TABLE 1

Latin America and the Caribbean: Sector-specific financial and fiscal incentives

Country	Lending to specific sectors, except agriculture	Fiscal incentives for specific sectors
Argentina	Capital goods	Mining, forestry
Bahamas		Hotels, financial services, beer and alcoholic beverages
Barbados		Financial services, insurance, information technologies, tourism
Belize		Mining
Bolivia		Mining
Brazil	Oil, natural gas, textiles, wearing apparel, footwear, shipping industry, electricity, telecommunications, software, film-making	Automotive industry, electronics
Chile		Forestry, oil, nuclear materials
Colombia	Film-making	
Costa Rica	Various sectors	Forestry, tourism
Ecuador		Mining, tourism
El Salvador	Mining, services (tourism, transport, software and others)	
Guatemala		
Guyana		Agroindustry, forestry, mining, tourism, fishing, construction, information and communication technologies (ICTS)
Haiti		
Honduras	Transport, shrimp	
Jamaica		Film-making, tourism, bauxite, aluminium, factory construction
Mexico	Film-making	Forestry, film-making, air and sea transport, printing and publishing
Nicaragua		Tourism
Panama		Tourism, forestry
Paraguay		
Peru		Tourism, mining, oil
Dominican Republic		Tourism, agroindustry
Suriname		
Trinidad and Tobago		Hydrocarbons, tourism, construction
Uruguay		Mutton, vineyards and wine, hydrocarbons, printing, forestry, military-industrial, airlines, newspapers, radio stations, theatres, film-making
Venezuela (Bolivarian Republic of)		Hydrocarbons and purchases of capital goods and services for investments in primary sectors (oil, mining, agriculture and fishing).

Source: Prepared by the author on the basis of Melo (2001, table 3).

play an important role in the financing of domestic market-oriented production activity in the industrial sector; in 2002, its operations exceeded US$ 5.8 billion (ECLAC, 2004a, table 8.2).[18]

[18] The "Others" category of the NAFIN portfolio, accounting for 97% of the total, probably includes operations oriented towards the domestic production sector.

The second variable allows the countries of the region to be differentiated by the frequency or intensity with which they conduct sectoral policies: (i) countries that implement a wide range of sectoral policies (such as Brazil, Colombia, Guyana, Mexico, Uruguay, the Bolivarian Republic of Venezuela); (ii) countries that implement them for only a small number of activities (Bolivia, Chile, the Dominican Republic, Peru, among others); and (iii) countries where these policies are almost non-existent (such as Haiti, Paraguay and Suriname). Besides the information provided by table 1, the intensity with which sectoral policies are implemented can also be gauged from measures that do not involve fiscal and financial subsidies, as in the case of Colombia, where there is a very active policy of sectoral agreements that do not include incentives of this type, or El Salvador, a country that has an active policy of supporting clusters (Alonso, 2003).

In Mexico, since the Política Económica para la Competitividad (Economic Policy for Competitiveness) was inaugurated in 2002, 12 priority production branches have been chosen to benefit from sectoral programmes: four of these are in operation (for the fibre, textiles and wearing apparel chain; for leather and footwear; for the electronics and high technology industry; and for software) and there has been progress with some programmes for the automotive industry, export *maquila* and chemicals.[19] In November 2003, meanwhile, the Government of Brazil published its industrial, technological and external trade policy guidelines, setting out its strategic sectoral options in four knowledge-intensive production activities (semiconductors, software, pharmaceuticals and medicines, and capital goods), and created a special body to coordinate implementation of this policy, the Agência Brasileira de Desenvolvimento Industrial (Brazilian Industrial Development Agency).[20]

In some countries (Costa Rica, Peru and Uruguay, among others), promotional measures have been targeted even more closely, to the extent that support has been given to the individual projects of particular companies. Some examples are the incentives for investment in megaprojects in the Peruvian mining sector,[21] the measures taken by the government of Costa Rica so that INTEL would establish an operation in the country,[22] and tax exemptions to support projects declared to be of national interest in Uruguay.[23]

The third variable, the level of coordination between the measures applied, requires consideration of a further dimension that concerns the logic of the policies on which they are based: the question of whether or not they are integrated into a broader national strategy. Three types of countries need to be distinguished, then: those that take frequent measures as part of explicit public intervention strategies, usually expressed in official plans or programmes (Brazil, Colombia, El Salvador and Mexico, for example); countries that intervene frequently, but without an explicit strategy (Costa Rica, Uruguay) and countries that intervene sporadically (the great majority).

The three variables considered have remained very stable in each of the countries over time, which is indicative of competence and experience in policy formulation and application. Changes of government, even when they have meant a sharp break with a country's political past, as in Mexico in 2000 or Uruguay in 2005, have not led to great alterations in policy stances. Two examples, albeit tending in opposite directions, are the relative unimportance of sectoral policies that is still a feature of Chile, and the continuity of efforts to formulate and maintain sectoral agreements (export competitiveness pacts) in Colombia over the administrations of presidents Samper, Pastrana and Uribe, involving as they do 41 production chains and sectors responsible for 86% of non-traditional exports.[24]

[19] The other five branches of industry are aerospace, agriculture, tourism, commerce and construction (Secretaría de Economía, 2003).

[20] The document states that these sectors were chosen because (i) they display increasing and sustained dynamism; (ii) they account for large shares of international research and development investment; (iii) they open up new business opportunities; (iv) they are directly linked to innovation in processes, products and forms of use; (v) they increase the density of the industrial fabric; and (vi) they are important for the future of the country and have potential for the development of dynamic comparative advantages (Ministério do Desenvolvimento, Indústria e Comércio Exterior, 2003, p. 16).

[21] The main support policies for the Peruvian mining sector in the 1990s were: promotion of and guarantees for foreign direct investment; privatization of State enterprises; approval of a framework law guaranteeing free enterprise and private investments; tax, currency and administrative stability; modernization of the mining concession process; fiscal benefits (reinvested profits are free of income tax); fiscal incentives for investment in megaprojects (income tax exemptions and accelerated recovery of the general sales tax). See Fairlie (2003).

[22] See Alonso (2003).

[23] The 1998 investments law promotes specific investments, the requirement being a declaration by the executive that a particular project is of national interest. Benefits may be general or favour only the project concerned (e.g., exemption from the asset tax on movable goods). General benefits may be automatic (e.g., exemption from the asset tax on movable goods for use in the production cycle) or discretionary (the regulations for this had yet to be issued as of mid-2003). See Scarone (2003).

[24] Of these chains and sectors, 31 are national and 10 regional; 29 produce goods and 12 services. Strictly speaking, not all the programmes concern production chains, since the sectors covered include potatoes, farmed shrimp, tuna, wild shrimp, flowers, coffee and bananas. The production chain concept was not rigorously applied because these agreements were signed for "practical reasons" in an effort to bring businesses on board (Velasco, 2003).

Positive though these examples of institutional maturity are, their implications should not be overstated, because the experience of the region also abounds in examples of programmes established to palliate efficiency problems that have led to crises.[25] Even the policy for the Brazilian automotive industry has features suggestive of a rescue for a struggling sector that cannot withstand external competition or, to use the term current in the 1980s, of an industrial restructuring exercise (Bonelli and Motta Veiga, 2003).

III

Lines of action and instruments

As the specialized literature has often pointed out,[26] competitiveness policies in the region, even those that are fundamentally sectoral in scope, have concerned themselves far more with increasing the efficiency of existing sectors than with creating new ones, something that is consistent with a quest for greater international market share relying chiefly on static comparative advantages (unskilled labour and natural resources). This has happened both in countries with a diversified production structure (Brazil and Mexico, among others) and in countries with more specialized structures. Of the former it might be said that only a very few sectors are wholly absent from their economies and that sectoral policies should be detected at the individual product level. While this is true, the evidence suggests that, particularly in Brazil and to a lesser extent in Mexico,[27] sectoral type measures have focused on strengthening and expanding established sectors, the most noteworthy example being the automotive industry, as indicated earlier.

The creation of new activities comes up sporadically as a policy objective, and two main lines of action have been followed to this end: international trade negotiations to secure market access, chiefly through bilateral or multilateral free trade agreements, and efforts to attract foreign direct investment (FDI) to develop export platforms, including free trade zone and *maquila* activities.

Attracting FDI has been the main mechanism used to create new sectors in most of the region's countries. Measures of this kind include the deepening of the Mexican export platform within the framework of the North American Free Trade Agreement (cars and car parts, electronics and clothing), more elementary first-generation *maquila* activities in some Central American and Caribbean countries (wearing apparel) and investments in privatized service and commodity sectors in South American countries (Mortimore, 2000; Peres and Reinhardt, 2000). The activities leading to the diversification of production structures have largely been determined by the different combinations of strategies followed by investing multinationals, on the one hand, and government sectoral policies, on the other, albeit with the limitations deriving from low value-added (owing to the preponderance of assembly activities) and a lack of linkages with the rest of the national economy concerned.

The instruments that have been used to attract foreign investment can be classified into three major groups (Mortimore and Peres, 1998): (i) incentives, chiefly in the form of free trade zones and fiscal benefits, (ii) the use of standards to create an efficient business environment (rule of law, transparency, assured access to international markets, good infrastructure, etc.) and (iii) the creation of specialized factors of production, particularly skilled labour. The countries of the region have applied these three types of instruments to differing degrees; with few exceptions, however, it is the first two that predominate.

Besides specific instruments to attract foreign investment, countries have used two others that apply to any kind of investment (domestic or foreign). These are the financial and fiscal incentives shown in table 1 and a large group of measures used by governments to create competitive environments for companies to work in (pro-competition measures and the regulation of monopoly sectors), lower transaction costs (by reducing administrative controls, among other things) or enable companies to act collectively to take advantage of economies of scale (sectoral agreements spanning production chains, support for partnerships between companies, etc.).

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[25] See Scarone (2003) concerning a large portion of the policies applied in Uruguay and Villagómez (2003) concerning the 2002-2010 programme for the electronics industry in Mexico.

[26] See IDB (2001), Melo (2001) and Peres (1997).

[27] See Bonelli and Motta Veiga (2003) on Brazil, and Unger (2003) and Villagómez (2003) on Mexico.

The policies formulated in the region can be grouped as follows, in accordance with the degree of acceptance they have attained: winning policies, losing policies and emerging policies (Peres, 1997). Winning policies are those that have been generally accepted by governments, i.e., that have strong legitimacy. In addition to the export promotion and inward FDI policies already mentioned, this group includes policies to promote technological development, human resources development, small businesses and microenterprises (usually in the form of support for the creation or strengthening of business networks or clusters) and productive development at the local or subnational level, these two last being very closely intertwined. These policies have proved so acceptable because of their perceived neutrality, since they operate on markets for production factors (technology and training), or because of their perceived positive impact on job creation, especially at the subnational or local level.

Losing policies, meanwhile, are those that are more clearly inconsistent with the current development model, particularly trade liberalization and public-sector deficit reduction. They include direct fiscal subsidies, directed lending and the use of subsidized interest rates, tariffs on foreign trade and the use of the State's purchasing power. Concerning this last, the situation varies from one country to another. While some use this instrument at the national or subnational level, as in the support programme for software production in Mexico already referred to, others regard it as being outside the range of applicable policies because it would go against objectives of spending efficiency and transparency.

Emerging policies, lastly, such as pro-competition measures, improvements to corporate governance regimes, regulation of infrastructure sectors whose markets do not operate efficiently, and corporate social responsibility, are acquiring growing legitimacy, but are still maturing and are at very different stages of development in the region's countries. Some have modern legislation and fairly solid institutions with which to implement these policies, while in others they are still at the stage of debate and decision-making, or are not a major item on the agenda.

National differences notwithstanding, the region has displayed a high degree of convergence in the content of policy documents over the last decade. There are four basic elements around which this convergence has taken place: (i) an emphasis on raising international competitiveness, (ii) horizontal or neutral instruments, whose legitimacy has become firmly established even though, as noted earlier, their effects in practice are far from neutral, (iii) support for small businesses and microenterprises, basically because of their capacity to generate jobs, and (iv) the targeting of subnational or local economic areas. Programmes to support clusters are the leading manifestation of at least three of these elements, the Brazilian programme of support for local production arrangements (APL) being perhaps the most important example in Latin America and the Caribbean.

IV

Evaluating industrial policy implementation and impact

Efforts to evaluate the implementation and effects of industrial policies are constrained not only by the information available, but also by the fact that, until very recently, these policies rarely specified which criteria and mechanisms should be used for evaluating them. The problem is compounded by the technical complexities involved in evaluating policies that have multiple objectives and lines of action.

1. Evaluating policy implementation

While there are data on the funding allocated to certain policies (actually programmes or projects),[28] the information is insufficient to evaluate implementation overall. Despite this, it has been shown that, with some exceptions, the degree of policy implementation in Latin America and the Caribbean is still low, as indicated in

[28] The best-documented cases concern the amounts allocated to agricultural policies, in particular those forming part of large programmes such as PROCAMPO, the Alianza para el Campo (Rural Alliance) and the Programa de Apoyo a la Comercialización (Marketing Support Programme) in Mexico. See Kjöllerström (2004), Villagómez (2003) on Mexico and Scarone (2003) on Uruguay.

Peres (1997); particularly clear analyses are provided by Alonso (2003) concerning the situation of the five Central American countries and Fairbanks and Lindsay (1997) concerning the Andean countries that designed competitiveness strategies around the concept of clusters.

According to these studies, the causes behind widespread policy implementation failures (i.e., "government failures"), and the resultant gap between what is decided and what is actually done, fall into a number of categories, as shown below.

a) *Non-operational or unattainable objectives*

The inclusion of non-operational or unattainable objectives in policy formulation transfers real implementation decisions to the budgetary allocation stage. The problem in these cases is that because of shortcomings in their formulation, policies tend to be more akin to declarations of intent than to resource allocation instruments. Evaluation of the 41 sectoral agreements in Colombia to determine the factors conductive to success shows that: (i) agreements containing well-structured, quantifiable and time-limited commitments are easier to follow and implement; (ii) agreements comprising just a few simple commitments achieve greater results; (iii) the leadership and decision-making capabilities of the people behind the agreements are fundamental; and (iv) production chains that had been supported since before the agreements achieved better results.[29] The practice followed in the region does not usually take these success factors into account. Thus, policy documents tend to end up as veritable "shopping lists" of needs and objectives. While the multiplicity of objectives may be due to the action of numerous agents in complex societies, it also reflects a certain inability to set priorities and build consensus around a few that can realistically be achieved.

b) *Shortages of human and financial resources*

Shortages of the human and financial resources needed for policy implementation, especially serious in smaller and poorer countries, often mean reliance on external resources (lending or aid) to make policy and, especially, to enforce it. When policies are rolled out, furthermore, their cost and the consequent financing needs are not usually considered, the approach being once again "decide first and then see what can be done and how it can be afforded".

[29] See Velasco (2003).

c) *Lack of institutional capabilities*

Almost all the countries in the region are deficient in the institutional capabilities needed to implement policies, even some quite straightforward ones. The difficulties increase when countries try to introduce policies that are more a reflection of "international best practice" than of their own actual needs. This results in policy formulations that are detached from reality and, worse still, are often sponsored by State agencies with little weight in the government power structure or by business associations that are unrepresentative and have little economic or political influence. The problem is compounded by the fact that policymaking and implementation authorities are usually separated in the region. Although countries can increase their institutional capacity over time, and some in the region have done so, institutional creativity and innovation require stability of objectives over longer periods than the four- to six-year terms that are the norm for governments in Latin America and the Caribbean, together with financial resources to make action possible. The great disparity in tax burdens between the different countries of the region, ranging from under 10% to over 30% of GDP, means there are structural differences in the potential for progress in this area.

d) *The unreliability of public-private agreements*

Policy implementation agreements between government and the private sector are unreliable, as transpires when the time comes for the public sector to release funds or for the private sector to make matching investment and spending commitments. Furthermore, there is a proliferation of plans and programmes that are only produced in reaction to political pressure from economic actors, or as a means of soliciting international financing, or to comply with legal or constitutional provisions. Businesses, which vigorously defended protection policies until the late 1970s, are not showing the same robust commitment to policies for diversifying and improving productive specialization in the region's countries.[30]

e) *The weakness of economic signals*

Implementation problems are compounded, in the case of industrial policies, by the weakness of the economic signals sent out by programmes to expand

[30] Again, while disagreements between governments and the private sector have diminished, they have by no means disappeared, as Alonso (2003) points out in relation to Guatemala and Scarone (2003) in relation to Uruguay.

activities or create new ones. By contrast with the vigour and clarity of the signal associated with the trade protection typical of the import substitution industrialization model, which made it possible to set domestic prices and maximize profitability, what businesses are now offered, at best, is a set of signals which are difficult to interpret and translate into concrete measures, and whose implications for profitability are uncertain. It should not be surprising, then, if the perception that "policies don't work" is widespread.

Implementation failures and the perception that "policies don't work" affect the legitimacy of industrial policies and the interest they may arouse among businesses, their main beneficiaries. This leads to a paradoxical situation: businesses consider that the resources available for policy implementation are inadequate, and yet they do not make full use of them. Finding out how to overcome implementation failures and make policies work is one of the main challenges for development strategies.

Despite the implementation failures referred to, there has been progress with the relationship between the public authorities and business associations (or chambers) at the policymaking stage and, in a few cases, at the implementation stage. Public-private dialogue has been strengthening since the early 1990s, although there are still conflicts, and has progressed to the point where business organizations often take the lead in proposing policy initiatives. This has happened with the Asociación Nacional de Industriales (ANDI) in Colombia, the Cámara Nacional de la Industria de Transformación (CANACINTRA) in Mexico, the Asociación de Industriales de República Dominicana (AIRD) in the Dominican Republic, the Cámara de Industrias de Costa Rica (CICR) in Costa Rica and the Federación de Cámaras Industriales de Centroamérica (FECAICA), a body which promoted an industrial modernization agenda in Central America in the 1990s. In these and other countries, then, it is possible to speak of shared public-private responsibility in policymaking, rather than just discussion and consensus-seeking (Peres, 1997).

Business associations have also participated to varying degrees in forums to negotiate competitiveness-boosting measures, such as the Consejo Nacional de Competitividad in Colombia, the Foro de Desarrollo Productivo in Chile and the "sectoral chambers" in Brazil.[31] In some cases, they have gone so far as to make long-term proposals to endow policies with stability beyond the individual terms of governments; this happened, for instance, with Visión 2020, an initiative of the Confederación de Cámaras Industriales de los Estados Unidos Mexicanos (CONCAMIN).

The policymaking role of other civil society organizations has been much weaker. Although labour unions have been represented in policy consensus forums, they have not had a decisive influence on their dynamic, with few exceptions; one such was the role played by the union organization in the "sectoral chamber" of the Brazilian automotive industry. Other bodies have played even less of a role, an exception being the participation of academics in the Consejo Nacional de Competitividad (National Council for Competitiveness) in Colombia.

2. Evaluating policy impact

The steps taken to evaluate the effects of industrial policies have been as limited and unsatisfactory as the efforts to evaluate their implementation, if not more so. There have been evaluations of some specific programmes, such as small business support programmes in Chile,[32] plus general evaluations of what has happened *after* policies have been applied, but without any effort being made to show that the policies have been the *cause* of the developments described. Some evaluations of this type have dealt with the increase in non-traditional exports from production chains with sectoral agreements in Colombia (Velasco, 2003), the increase in mining exports from Peru (Fairlie, 2003), improvements in the incomes of rural producers and indeed in the productivity of their farms following the large agricultural programmes in Mexico (Villagómez, 2003), and the discussion as to whether or not producers supported by the National Institute for Agricultural Development (INDAP) in Chile have increased their autonomous incomes (Kjöllerström, 2004).

What can be done to close the gap between what is decided and announced, and what is actually done and evaluated? Three lines of action, which are not mutually exclusive, look promising and should be followed up.

First, policymaking should be accompanied, not followed, by explicit considerations as to which institutions are responsible for implementation. This

[31] In Brazil, the expression "sectoral chamber" does not indicate an employers' association but a tripartite negotiating forum (State, businesses and workers).

[32] See Silva and Sandoval (2003) for evaluations of support programmes in Chile.

means that those involved with industrial policy will have to venture into matters of State reform. The State is still structured around the organization of production sectors and subsectors, whereas the aim now is to apply system-wide or transversal policies which, by definition, will cover more than one sector or more than one implementing agency. This is particularly important in the case of policies that were strictly sectoral to begin with but have since become general, such as strategies to support the spread and use of information and communication technologies, whose transversal character has already been noted. Reform of the State and the institutional development that this entails are not subjects familiar to industrial organization specialists, but they need to be addressed if implementation failures are to be reduced.

Given the shortage of qualified human resources in those areas of the State that are involved in policy implementation, a second line of action would be to transfer to these areas highly qualified staff who are currently engaged in policymaking. This would not undermine capacity-building efforts, since these efforts are necessarily long-term while the reallocation of human resources can be short-term. Reallocation of this kind is bound to be costly, of course, in terms of both efficiency and individual careers, but it is an alternative that deserves consideration once it is accepted that there is a large discrepancy between stated aims and the actual measures taken.

A third line of action is to develop and strengthen policy operators, i.e., institutions and individuals who combine policymaking capabilities with a capacity for action. This can be done by reinforcing public institutions, seeking out leaders in the private sector and bolstering intermediate agents such as business associations and non-governmental organizations.

Long-term institutional development within the State is something that is already under way in ministries responsible for macroeconomic policy and in central banks in Latin America and the Caribbean. In the agricultural and extractive sectors, too, many countries in the region have created and maintained vigorous institutions, examples being the Empresa Brasileira de Pesquisa Agropecuária (EMBRAPA), an agricultural research organization in Brazil, and the oil institutes of Mexico and the Bolivarian Republic of Venezuela. This experience can and must be emulated in areas linked to the development of other production sectors. Private-sector policy leadership has been efficient in some cases (the formation of certain clusters at the local level, for example), and needs to be employed whenever possible, but it has proved difficult to systematize in the region and its distribution has not matched implementation needs. Thus, economically weak sectors, which need major efforts from policy operators, tend to be weak in leadership as well. Strengthening intermediate-level implementation bodies has been a successful strategy in countries such as Chile, where it has been used for programmes to support productive linkages (PROFO), although the predictable problems of adverse selection and moral hazard have not gone away.

None of these measures is a panacea, nor will implementation be easy. They do open up new options, however, and deserve to be considered from perspectives that combine the economic, institutional and administrative dimensions.

V
Conclusion

This study has shown that the countries of Latin America and the Caribbean have policy options for improving their productive specialization, and that they have used them. Three types of policies have been shaped in the region in the light of the objectives, experience and economic and institutional capacity of the individual countries. More particularly, the measures designed range from industrial policies in the strict sense of the term to what are basically horizontal policies focused on particular sectors and support for clusters with a value chain approach (Porter, 1990).

Industrial policies are the core of specialization or diversification strategies. With strategies of this type, there are four major aspects to be considered: the criteria for deciding which sectors to support, the policy instruments available, the constraints imposed by the size of national markets and accumulated capabilities in the different countries of the region, and the political will to take measures of this type.

The choice of sectors must set out from the recognition that there are no universal criteria for deciding which activities ought to be promoted. There is a large body of international experience, however, which shows that in practice countries have chosen and continue to choose sectors in accordance with a few more or less precise criteria. Chief among these criteria are the knowledge content of the activities concerned, dynamism in the international market because of a high level of elasticity in relation to world income and especially the income of developed countries, and potential for productivity growth. Another consideration is the strategic character of certain activities, essentially because they account for a large share of total output, exports or employment, usually at the national level but sometimes at the local or subnational level as well. The review of policies in the previous sections provides a good illustration of how these criteria are used, not always explicitly, in the countries of the region.

Since the 1980s, the technology dimension has been increasingly important for determining the scope of industrial policies. Although the term "sector" has traditionally been applied to groups of activities whose common feature is the production of goods or services with a high cross-elasticity of demand, it can also be used for activities that have a common technological development path (Robinson, 1953); thus, we speak of the aerospace sector, the biotechnology sector and the information and communication technology sector. When it comes to encouraging activities that share a particular technology, the focus has sometimes been on horizontal policies, while at other times intervention has been focused directly on particular companies, market segments or knowledge networks. Just as industrial policies designed to create linkages between production activities have tended to concentrate on supporting clusters, in the field of technology they are almost indistinguishable from technological development or innovation policies.

As policies become systemic in scope, special attention needs to be paid to their impact on the conditions for competitiveness in the economy as a whole. The extra costs associated with the early phases of learning curves must not be so great that they jeopardize the competitiveness of the businesses using the new goods or services, especially if these businesses are strongly oriented towards external trade. It is not easy to strike the right balance between supporting diversification of the nation's productive apparatus and taking advantage of opportunities to import cheaper or technologically superior capital goods and inputs; this balance can only be sought through experimentation and trial and error, i.e., through policies of a pragmatic rather than doctrinaire cast. Since pragmatic policies tend to be reactive, a major challenge for the region is to combine pragmatism with much more proactive policies.

The instruments available for implementing policies of this kind are well known and are utilized by policymakers in the Latin American and Caribbean countries. By contrast with the former situation in the region and elsewhere, however, economies are now open and it is not possible to use permanent, across-the-board trade protection instruments. This constraint weakens the economic signal (expected returns) sent out to potential investors in new activities and means that a significant part of the cost of promotional measures has to be met by the State. This creates problems both for the selection of budget priorities and for the stability of budgetary allocations at times of fiscal tightening. Sustaining development mechanisms over the long run so that they outlast individual terms of government is a challenge that the countries of the region have yet to address successfully. Another powerful instrument of sectoral policy, direct State investment, is off the agenda in many of the region's countries; yet there is a great deal of room for manoeuvre in this area, as a number of cases show, particularly at the local or subnational level. The experience of the region suggests that while the cumulative effects of the policy combinations applied so far have yet to be evaluated, the inducements they create are weaker than those offered by protection in its day.

It has been argued that small countries with more limited institutional capacity should not and cannot introduce policies that are sectoral in scope. While it is certainly important that the domestic market could be used to achieve economies of scale and learning, it cannot be denied that this is less of an issue in open economies, as shown by the experience of numerous small countries that operate as highly competitive export platforms. That institutional capacity is a significant requirement is not in doubt, particularly in the short term, but the fact of its being limited does not mean that sector-wide activities need be ruled out, but rather that they should be focused on subsectors, segments or even products for which existing capabilities suffice. The alternative is to scale down the efforts made and not take "leaps in the dark". The experience of the region with cluster policies reveals that even small countries have succeeded in creating policies to improve their pattern of specialization.

Despite these considerations, there is no consistent political will to implement sectoral initiatives in the region. They have more legitimacy in some countries (although never as much as the earlier import substitution industrialization model) and much less, or none, in others. Even in countries that do not regard sectoral policies as legitimate, however, they are still practised, albeit in a much more ad hoc way, and specific support measures are often applied to crisis-hit sectors. Given that these policies are necessary for development in the region, the question is what has to be done to increase their legitimacy.

Two lines of action are paramount. First, there is a need to improve implementation capacity to narrow the gap between the policies formulated and the ability of institutions to put them into effect; the persistence of this gap damages the credibility of policymakers, and thence of the policies themselves. Second, considerable progress is needed in the task of evaluating the impact of policies in relation to their ultimate objectives: economic growth, technological progress, higher productivity. Given the scarcity of public resources, only robust evaluations can create the scope for reallocating resources from other policy areas to these.

These observations are not new, but they are crucial.[33] There have been advances, as is illustrated by the Programa de Desarrollo Empresarial de México 2001-2006, a Mexican business development programme which makes explicit reference to quantitative targets,[34] thus showing a clear improvement over earlier programmes. Progress in the region as a whole has certainly been inadequate, however. This is seriously affecting policies which have to compete for fiscal resources with others that enjoy great legitimacy, such as basic education, public health and civic security, and which have to justify their very existence. Given that they are essential for diversifying the production apparatus and laying the groundwork for faster productivity growth, industrial policies need to regain legitimacy, and to do this they have to show that they work.

From a broader perspective, a crucial question remains open. Even if policies for diversifying the production structure could demonstrate their technical ability to generate positive impacts, it would not be clear which social agents would be interested in seeing these policies applied on a wide scale in the region's countries, i.e., which agents would pledge their economic and political resources to initiatives of this type that went beyond the promotion of clusters, the great majority of which are in any case far from well-funded. Industrial policies have made a slow comeback in the region and have been able to operate, albeit on a small scale, in open economies with orthodox macroeconomic policies, despite the prior belief that the latter would be incompatible with the use of industrial policies. For these policies to have more than a marginal impact, social actors, including the State, will have to commit themselves to them and back them up with their authority and resources. And here the fundamental question arises: who has or might have an interest in proactive industrial policies while at the same time possessing the strength and resources to alter the current pattern of productive specialization?

(*Original: Spanish*)

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[33] This idea has been highlighted in Peres (1997), Stallings and Peres (2000) and Peres and Stumpo (2002).

[34] The programme proposes the creation of a public evaluation system to include strategic indicators, oversight mechanisms, mechanisms for coordination and participation in evaluation work, periodic reporting and an observatory of small and medium-sized businesses and microenterprises to act as an information source (Secretaría de Economía, 2001, p. 56).

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A low-growth model: Informality as a structural constraint

Mario Cimoli, Annalisa Primi and Maurizio Pugno

After years of reforms and unending debate, the question remains unanswered: why is Latin America not growing more? The present article approaches the subject from an unconventional perspective, presenting the persistence of informality as a structural barrier to growth. As an analytical frame of reference, it introduces a 2 x 2 model of growth in which the economy comprises just two sectors, the formal and the informal. The model presents the links between the growth pattern of the formal sector and the dynamics of the informal sector, and between these and the pattern of growth in the overall economy. Adverse specialization patterns and an unfavourable international trade profile are perpetuating informality. Thus, export-led growth most resembles an enclave model which does not even guarantee high growth, since the dynamic of the informal sector, which accounts for about half the urban workforce, adversely affects the performance of the whole economy.

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I
Introduction

After years of reforms and unending discussion, it is still unclear why Latin America is not growing more. More than ever, accelerating productivity, output and employment growth is now a threefold challenge for the region. While it is true that the structural reforms of the 1990s brought macroeconomic stability and checked inflationary pressures, there is a growing consensus that further measures are needed to achieve sustained output growth and reduce poverty. Indeed, growth and poverty remain crucial issues for the region. From a long-term perspective, comparisons between the current performance of the region and that of the period prior to the "lost decade" are not encouraging. Latin America's gross domestic product (GDP) grew by an average of 5.6% a year in 1945-1980, 3.8% a year between 1990 and 1997 and just 2.5% a year between 1998 and 2004, with an upturn only towards the end of the period. Annual per capita income growth, meanwhile, averaged 3.1% between 1945 and 1980, 1.9% in the seven years following the lost decade and 0.5% between 1998 and 2004. Meanwhile, the problem of poverty remains: poor households averaged 35% of the total between 1945 and 1980, 35.5% in 1990-1997 and 36.1% in 2002 (ECLAC, 2002, 2004a and 2005; Cimoli, Primi and Stumpo, 2004). Despite the wave of optimism produced by the recent upturn in the growth rate, convergence between the per capita GDP of Latin America and that of the technology frontier is still not being achieved. In attempting to understand the reasons for this, the present study adopts an unconventional perspective: it concentrates on the informal sector as a structural barrier to sustained growth. Thus, the simultaneous existence of the formal and informal sectors is seen as a peculiar form of structural heterogeneity that hinders the development of the region.

As a frame of reference for the analysis, this study, in addition to presenting some empirical evidence, formulates a 2 x 2 model which assumes the existence of just two sectors in the economy: the formal and the informal.[1] This model uses a structuralist approach to examine the relationship between the growth pattern of the formal sector and the dynamics of the informal sector, plus the effects of these dynamics on the pattern of overall growth, and it succeeds in relating them in a highly stylized way to yield a framework of slow growth. The presence of unfavourable specialization patterns and a "low-quality" international trade profile foster what are also adverse dynamics in the formal sector, thus contributing to the expansion of the informal sector. It is on this basis that we argue that the export-led growth pattern of Latin America tends to be of the enclave type and does not even guarantee high rates of growth, since having about half the urban labour force working in the informal sector reduces the performance of the economy as a whole.

What is advocated, accordingly, is a change in the specialization pattern of the formal sector to remedy its unfavourable international trade specialization and speed up its rates of productivity and output growth, with a view to increasing formal employment, reducing the weight of the informal sector and improving economic performance overall.

☐ An earlier version of this paper was presented at the GRADE workshop "A Micro Approach to Poverty Analysis" held by the University of Trento, Italy, in February 2005, and also at the meeting of the industrial policy working group of the Initiative for Policy Dialogue (IPD) held in Rio de Janeiro in March 2005. The authors are particularly grateful for the valuable comments of Oscar Altimir, Giovanni Dosi and Richard Nelson.

[1] The assumption that there are only two sectors in the economy is a simplification, since the reality is actually far more complex and there are different productive strata which blur this demarcation in various ways. Nonetheless, 2 x 2 models are a standard instrument in the economic literature, especially in cases of structural heterogeneity where a tradable goods-oriented sector and a non-tradable goods-oriented sector are identified. The model presented in this article may be a particular case of this type. In our case, obviously, the assumption that the economy is composed only of a formal sector and an informal sector is adopted exclusively to simplify the model. At the same time, this assumption is supported by empirical estimates for the persistence of the share of urban employment accounted for by the informal sector (about 50% of the total). Again, there is a large body of literature on the structural heterogeneity of the formal sector, especially as regards manufacturing industry (Pinto, 1970 and 1976; Cimoli, 2005), and it is possible to use an analytical framework similar to the one proposed in this article to give a more nuanced view of structural heterogeneity in the formal sector by applying the dynamics described here for the informal sector to low-productivity strata in the formal sector.

The concept of informality requires some explanation before the model is introduced. The concept of an informal economy actually dates from an International Labour Organization (ILO) mission to Kenya in 1972; it was used then for the first time to identify the huge mass of working poor who survived, produced and subsisted outside the legal framework, in what was then termed the "unstructured sector" (ILO, 1972).

At least three main currents can now be identified in studies dealing with informal employment, differing from one another in their definitions and policy recommendations (Rosenbluth, 1994; Maldonado, 1995). According to the orthodox approach, which easily predominates, the informal sector is a consequence of State intervention: the excess of regulation and bureaucratic requirements makes participating in the formal sector an extremely burdensome option (De Soto, 1986; Loayaza, 1997). Rather than a problem in itself, therefore, informal employment is seen as a voluntary solution for rational economic actors who opt for it because of the excessive regulations and obligations imposed by the formal sector. Accordingly, liberalizing the labour market, establishing property rights and cutting back State regulation should diminish the informal sector. Paradoxically, it is believed that legalization of this kind can provide a substitute for business capacity and create jobs. An even more optimistic theory holds that by moving into the informal sector, workers gain in flexibility and freedom to set their working hours, so that there is no need to apply welfare policies.[2] The orthodox approach certainly does capture some aspects of informal-sector dynamics, but it does not do justice to the depth of insecurity and marginalization characterizing most informal activities in developing countries, and in failing to consider the relationships between the dynamism of the formal sector and informal employment, it also fails to explain why Latin America is not growing more.

A slightly different view of the informal sector is provided by the institutional approach (Piore and Sabel, 1984). Globalization and the increasing interdependence of global trends has had the effect of making demand more unstable and generating radical changes in production methods and labour organization. In their desire to maximize profits, companies have adopted cost reduction strategies based on new contractual arrangements such as outsourcing and subcontracts, thus giving rise to a kind of "informal" working or an "informalization of formal activities".[3] This view, however, applies more to economic agents in developed countries that shift their production activity to other countries to take advantage of wage differentials than it does to what happens within developing economies.

Thirdly, there is the structuralist approach, whose pioneers were Prebisch, Pinto and the members of the Regional Employment Programme for Latin America and the Caribbean (PREALC). In their view, the informal sector originates in international trade specialization and the consequent imperfect functioning of the formal sector, which is unable to employ and train labour adequately. The informal sector is a sort of refuge or subsistence strategy for marginalized groups that reinforces, if it does not generate, social strains and exclusion. From the macroeconomic point of view, then, the informal sector hinders economic growth and increases wage disparities. As an alternative to orthodox liberalization and legalization policies, therefore, structuralists support the application of realistic industrial and production policies to support structural change and labour absorption in the formal sector and thus raise growth in the economy.

Notwithstanding the differences between the various strands of thought, there is general agreement that the informal sector includes heterogeneous activities ranging from highly unstable street work to own-account and waged activities. Undeniably, though, one common characteristic of all informal activities is low productivity, owing to the use of obsolete technologies and unskilled labour, and to the small size of businesses (Castells, Portes and Benton, 1989; Rosenbluth, 1994; Tokman, 2001; Maloney, 2004).

[2] Maloney (2004) offers evidence for this. Goldberg and Pavcnik (2003), on the other hand, provide empirical evidence of the disadvantages of informal as opposed to formal employment.

[3] Recent studies, though, show that large firms are subcontracting less work to informal microenterprises than they used to (Sánchez, Joo and Zappala, 2001).

II

The informal sector: an unconventional look at structural heterogeneity

Structural heterogeneity is not a new feature of the production system in Latin America. Prebisch (1949, 1962 and 1970),[4] Singer (1950) and Pinto (1970 and 1976) were well aware of the dualism in the region and highlighted the simultaneous existence of a highly productive, mainly outward-oriented sector and a variety of low-productivity activities oriented towards the domestic market. Reallocating factors of production from low-productivity to high-productivity activities was believed to be a necessary precondition for setting the economy on a virtuous development path. A structural change, namely an increase in the share of manufacturing in the overall economy, would be required for activities with low productivity to converge upon high-productivity ones. Industry was seen as the main driver of productivity growth. According to this approach, industrial development would generate the forward and backward linkages, spillover effects, capital accumulation and technological externalities needed to sustain increasing returns. The region would shed its peripheral status as structural heterogeneity, identified with the concentration of employment in low-productivity work, diminished.

In today's open economies, after a decade of reforms, heterogeneity remains a structural weakness of the Latin American production system, while the concentration of technical progress has not only persisted but worsened. Liberalization has favoured a reorientation of specialization patterns towards natural resource- and labour-intensive activities, along with privatization, modernization and improved production technology. These processes have transformed the dynamics of the formal sector by undermining endogenous technological capabilities, reducing the domestic production linkages and labour absorption capacity of the formal manufacturing sector, and thereby diminishing the capacity of that sector to act as a driver of development for the whole economy (Cimoli, 2005). The progressive erosion of labour absorption capacity in the formal manufacturing sector has increased unemployment and swelled the urban informal sector, which has been absorbing the surplus labour. Thus, the simultaneous existence of an outward-oriented modern sector which fails consistently to provide enough employment and of a low-productivity informal sector accounting for a large share of employment can be seen as a peculiar manifestation of structural heterogeneity. Hence, Latin America most resembles a polarized economy in which two sectors with different accumulation, production and growth dynamics coexist and in which the formal sector has the appearance of a growth-leading enclave.

The statistics on formal employment are not encouraging.[5] It is estimated that in 2003, 47% of urban employment in Latin America was informal (ECLAC, 2005; ILO, 2004; Weller, 2000). The weight of the informal sector in urban labour markets is fairly even across the region's countries, ranging from 39% in Chile to 67% in Bolivia. Indeed, despite the differences between the countries in specialization patterns and export structures,[6] persistent informal employment is a common characteristic of the Latin American economies (figure 1).

Empirical analyses of the informal sector have encountered serious limitations owing to the very nature of this phenomenon, which is difficult to identify and measure. Table 1 provides a rough quantification of structural differences in Latin America, considering the

[4] Prebisch's 1949 essay was later reprinted in Prebisch (1962). Both are cited because the latter is easier to find.

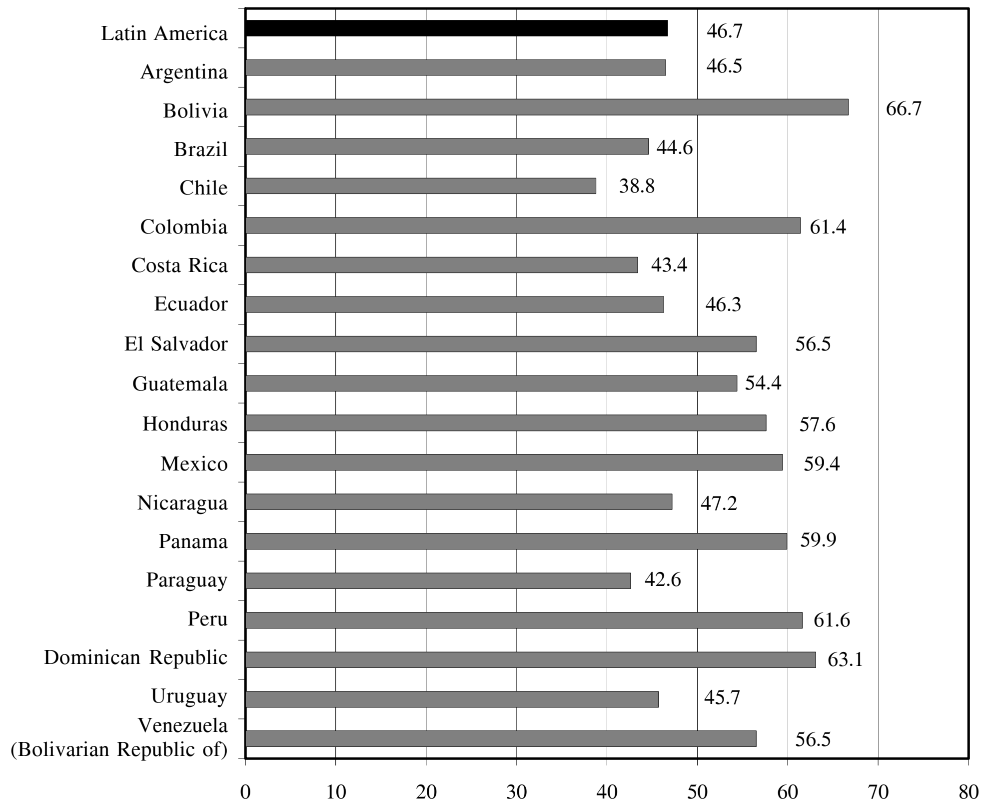
[5] The informal sector is, by definition, difficult to identify and measure. According to the standard United Nations approach (to which the methodologies of ECLAC and ILO conform), the informal sector comprises low-productivity occupations and includes the following categories: domestic service, waged non-professionals, unpaid family workers, and people working in microenterprises with less than five employees.

[6] Divergent specialization and commercialization patterns coexist in the region: some are labour-intensive, others are natural resource-intensive, and others are basically centred on primary or tertiary activities. See Cimoli (2005) for an up-to-date study of structural heterogeneity in Latin America.

FIGURE 1

Latin America: The persistence of informality in urban labour markets, 2003

(*Urban population working in the informal sector as a percentage of the working urban population*)



Source: Prepared by the authors from ECLAC and ILO data. The figures are estimates based on national household surveys and relate to the urban population working in low-productivity activities, which are treated as a proxy for the informal sector.

distribution of employment and the productivity of labour in the formal and informal sectors relative to the economy as a whole.[7] In 1990, 44% of urban employment was informal, while in 2000 the figure was 45%.

Informality is an increasingly entrenched feature of Latin American economies. Not only does it have adverse effects on economic performance in terms of exclusion, marginalization, insecurity and wage disparities, but it directly affects overall productivity, and hence growth, by reducing average productivity in the economy. Informal activities are low-productivity activities and the concentration of the workforce in the least productive sector drags overall productivity down. It is estimated that in the late 1990s, labour productivity in the informal sector was just 20% of that in the formal sector, and that the informal sector accounted for about half of total employment (table 1).

In 1990, almost half the workforce was in a sector whose productivity stood at 48% of overall productivity in the economy and around 33% of formal-sector productivity. By the end of the decade the situation was even more alarming. In 2000, around half of all urban employment was in the informal sector, and its productivity was just 30% of overall productivity and 20% of formal-sector productivity. Table 2 shows the ever-widening gap between formal-sector and informal-sector productivity in four countries of the region.

The fact that some 50% of employment on average is in the informal sector must have considerable

[7] The estimates for employment distribution and labour productivity are based on ECLAC data from national household surveys. Labour productivity in the informal sector is estimated from the average earnings of informal workers; these earnings are considered a good proxy for the value-added generated by the informal sector, given the nature of the activities carried out there.

TABLE 1

Latin America: The distribution of employment and productivity between the formal and informal sectors
(*Estimates*)

Year	Formal sector	Informal sector
	Distribution of employment (% of workers)	
1990	55.6	44.4
2000	54.6	45.4
	Labour productivity (overall productivity=100)	
1990	141.8	47.6
2000	157.8	30.5

Source: Cimoli, Correa and Primi (2003).

TABLE 2

Latin America (four countries): The widening productivity gap between the formal and informal sectors[a]
(*Percentages*)

Country	Informal-sector productivity/formal-sector productivity	
	1990	2000
Brazil	40.3	20.1
Mexico	31.9	28.2
Uruguay	24.2	16.9
Venezuela (Bolivarian Republic of)	39.5	32.9

Source: Authors' estimates based on ECLAC data.

[a] Labour productivity in the informal and formal sectors.

implications for overall growth. Analysing the dynamics of this sector may help explain why Latin America is not growing more, or as much as it should. The analytical framework used is a simple growth model adapted to a particular type of dual economy in which a formal sector coexists with an informal one.

For the purposes of simplification, the model focuses on the disparity between the formal and informal sectors in respect of growth, productivity, employment distribution and wages. It needs to be emphasized, however, that each of these sectors is far from homogeneous. The formal sector encompasses quite a variety of activities, such as industries that are labour- or knowledge-intensive and others that are based on the processing of natural resources, and these display different production, productivity and employment dynamics (Cimoli, 2005). Broadly speaking, however, these activities do have common characteristics, such as their orientation towards the external sector, relatively modern production processes and skilled labour, and company size (medium or large). The informal sector, meanwhile, encompasses heterogeneous activities (indeed, it includes corporate structures and waged work), but it is more homogeneous in its low productivity and in the low living standards and lack of qualifications of those who work there.[8]

The analysis is conducted using a traditional 2 x 2 model. Specifically, a dual economy is assumed, constituted by a formal sector and an informal sector. The output of the formal sector, Y_f, uses domestic inputs and is exported, whereas that of the informal sector, Y_i, goes exclusively to the domestic market.[9]

[8] The concept of informality needs to be distinguished from that of illegality, although in certain cases the two may coincide. Informal activities differ from illegal ones because they concern products or services that are legal, albeit illegally produced. Furthermore, the informal sector needs to be analysed from a different perspective in developing countries than in developed ones, where informality is more associated with tax evasion and the illegal provision of inputs for the formal sector.

[9] Appendix A explains the static part of the model and gives further analytical details of the specifications used.

According to the efficiency wage approach, which ensures labour market segmentation, productivity and wages are higher in the formal sector than in the informal sector.[10] According to this approach, formal-sector firms set a margin above the flexible wages of the informal sector, in consideration of formal-sector productivity.[11]

In this context, workers contend for formal jobs and formal-sector enterprises can select labour, thus increasing their productivity. In the formal sector, the level of demand will determine import and labour requirements, while the informal sector simply mops up any surplus labour. The residual nature of informal employment keeps the labour market segmented and intensifies the external constraint on growth.

III

The dynamics of output, productivity and employment: growth in a dual economy

The main model equations expressing the dynamics of the formal sector are the demand regime equation and the productivity regime equation (Setterfield and Cornwall, 2002). The first explains demand growth in an open economy, while the second endogenizes productivity growth in a way that is circular with respect to demand growth.

The demand regime represents the output growth of the formal sector, y_f, due to export demand.[12] The specification follows the Harrod-Kaldorian perspective,[13] as equation (9) synthetically describes.[14]

$$y_f = b\pi_f \quad \text{Demand regime (DR)} \tag{9}$$

$$b = \frac{x}{\varepsilon\pi^*} \tag{10}$$

where π_f stands for the productivity growth rate in the formal sector, π^* stands for the external productivity growth rate, x denotes export growth resulting from the increase in external income and ε denotes the income-elasticity of imports.

The economic implications of the demand regime are simple.[15] The less constraining the trade balance is, owing to export growth and the income-elasticity of imports, the faster the output of the formal sector (which is sold in international markets) will grow in the long run. In particular, the more quickly the productivity gap with the technology frontier is narrowed, the higher output growth will be, i.e., π_f/π^*. In fact, any increase in this ratio, known as the technological gap multiplier,

[10] In efficiency wage theory, the productivity of labour is positively related to wages, and the wage gap between industries or sectors is due to different factors (such as the desire to incentivize workers by increasing the opportunity cost to them of losing their jobs, or to raise the level of human capital by attracting workers with higher reserve wages). There are numerous studies based on the theory of efficiency wages in dual economies: Stiglitz (1974 and 1976), Bulow and Summers (1986), Esfahani and Salehi-Isfahani (1989), Agenor and Aizenman (1999), Goldberg and Pavcnik (2003). Arbache (2001) provides some information on Brazil. Tables 1 and 2 show some empirical evidence on the productivity gap between the formal and informal sectors while, further on, figure 4 shows the wage gap between the two sectors.

[11] The pay gap between the two sectors is a consequence of the efficiency wage approach. Furthermore, the margin set above informal-sector wages, which determines formal-sector pay, also depends on whether there is any substitute for the labour factor and on whether there are institutional arrangements in the formal labour market that may affect wages in that sector.

[12] Inclusion of the domestic demand growth component would not change the results of the model even if growth fell, as it has in Latin America.

[13] See, among others, Cimoli, Dosi and Soete (1986); Cimoli (1988 and 1994); Dutt (2001); Harrod (1933); Kaldor (1966 and 1975); Lawson, Palma and Sender (1989); McCombie and Thirlwall (1994); Thirlwall (1979).

[14] This specification does not consider the effects of real exchange rates, unlike Thirlwall's original model, which has been successfully tested for various Latin American countries by Gonzaga (2003), Moreno-Brid (1999a and 1999b) and Perraton (2003). The model proposed by Frenkel and Taylor (2006) in their recent study of the relationship between the real exchange rate and development, and in particular the effects of the real exchange rate on the labour market of an economy with two sectors, one specializing in tradable goods and the other in non-tradable goods, yields some interesting considerations.

[15] Appendix B presents the economic derivations and further details.

implies greater competitiveness in international markets. The technological gap, meanwhile, is mainly determined by technological learning capabilities, linkages and the level of diversification in the production structure.[16] With the demand regime, therefore, the model captures the capacity of the exporting sector to lead economic growth by raising competitiveness and alleviating external constraints, in accordance with the characteristics of the production structure.

The productivity regime equation follows the Verdoorn-Kaldor law,[17] i.e.:

(11) $\pi_f = \alpha + \beta y_f$ Productivity regime (PR)

with $\alpha > 0$ and $0 < \beta < 1$. The parameter α measures autonomous efforts that directly and indirectly influence productivity growth in the formal sector, such as human capital formation and capacity-building activities. The β coefficient captures structural learning and knowledge dissemination capacities and industrial linkages and complementarities, thereby accounting for the capacity of output growth to increase productivity.[18]

The demand regime (equation 9) and the productivity regime (equation 11) form a system of simultaneous equations. Therefore, the equilibrium solutions (indicated by subscript e) for output and productivity growth in the formal sector are:

(12) $$y_{fe} = \frac{b\alpha}{1 - b\beta}$$

(13) $$\pi_{fe} = \frac{\alpha}{1 - b\beta}$$

The equilibrium solutions for output and productivity in the formal sector depend on the labour market being segmented and the total labour supply not being constrained in practice.[19]

To represent the demand and productivity regimes in the space (π_f, y_f), equation (11) is turned into (14):

(14) $$y_f = -\frac{\alpha}{\beta} + \frac{1}{\beta}\pi_f$$

and thus (9) and (14) can be represented in figure 2.

To produce positive solutions it is necessary to assume that $b\beta < 1$, which is a realistic assumption. Hence, the greater the local linkages and the capabilities for transferring capacities are (i.e., the more complex the production structure, the greater the human capital formation and capacity-building efforts made and the more virtuous the international trade profile, or, to put it another way, the lower the income-elasticity of imports in respect of export growth), the better the pattern of output and productivity growth will be.

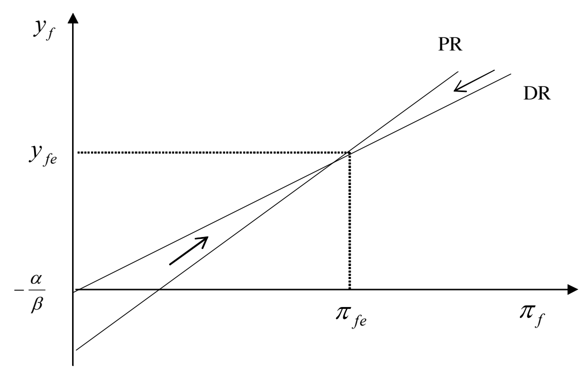
The same condition that ensures equilibrium solutions are positive means the equilibrium is stable from the dynamic point of view.[20]

Setting out from the definition of productivity, i.e., $\Pi_f = (Y_f / L_f)$, we get:

(15) $$\pi_f = y_f - l_f$$

FIGURE 2

Stable equilibrium condition: Output and productivity growth in the formal sector



Source: Prepared by the authors.

[16] See Cimoli and Correa (2005) for a detailed empirical analysis of the technological gap multiplier in Latin America before and after liberalization.

[17] On the Verdoorn-Kaldor equation, see Amable (1992); Kaldor (1975); McCombie and Thirlwall (1994); McCombie, Pugno and Soro (2002); Thirlwall (1979 and 1997).

[18] Learning determines agents' capacity for transforming and improving industrial production and organizational techniques, while linkages and network densities determine the potential for disseminating technology and know-how (Dosi and Freeman, 1992; Dosi, Pavitt and Soete, 1990).

[19] These conditions are usually assumed in the literature on externally constrained economic growth (McCombie and Thirlwall, 1994). In our model, however, wages are not set exclusively in the formal sector because of the efficiency wage determination. Pugno (1998) presents a growth model that simultaneously analyses the external constraint and the labour supply constraint on growth.

[20] If the starting value of π_f and y_f is outside the point of equilibrium, possibly after a change in the parameters, a circular process occurs between the demand regime and the productivity regime of the formal sector, and productivity and output growth end up by converging on the equilibrium values. Paus, Reinhardt and Robinson (2003) find a substantial two-way causality between productivity growth and export growth for Latin America on the basis of the Granger causality test.

The appropriate substitutions yield the equilibrium growth rate of formal employment:

$$l_{fe} = -\alpha \frac{1-b}{1-b\beta} \quad (16)$$

Equation (16) shows how important the characteristics of the production structure and the external trade pattern are for employment dynamics. In fact, the equilibrium rate for formal-sector employment will be negative or positive depending on whether ($0 < b < 1$) or ($1 < b < 1/\beta$), i.e., depending on the income-elasticity of imports and the rate of export growth (see equation 10 above).

If $b < 1$, a rise in β, which captures the scale of industrial linkages, knowledge dissemination, complementarities and human capital, is beneficial to productivity growth but not to employment growth in the formal sector. This is due to a binding external constraint on output growth. If $b > 1$, a rise in β becomes beneficial for both productivity and output growth, since the external constraint is not so binding.

Thus, export-led growth can create a vicious dynamic because of the characteristics of the production structure and the pattern of international trade participation, which can reinforce the external constraint on growth. At the same time, higher productivity in the formal sector may be accompanied by lower employment there, with the result that informal employment rises and whole-economy growth is reduced yet further.

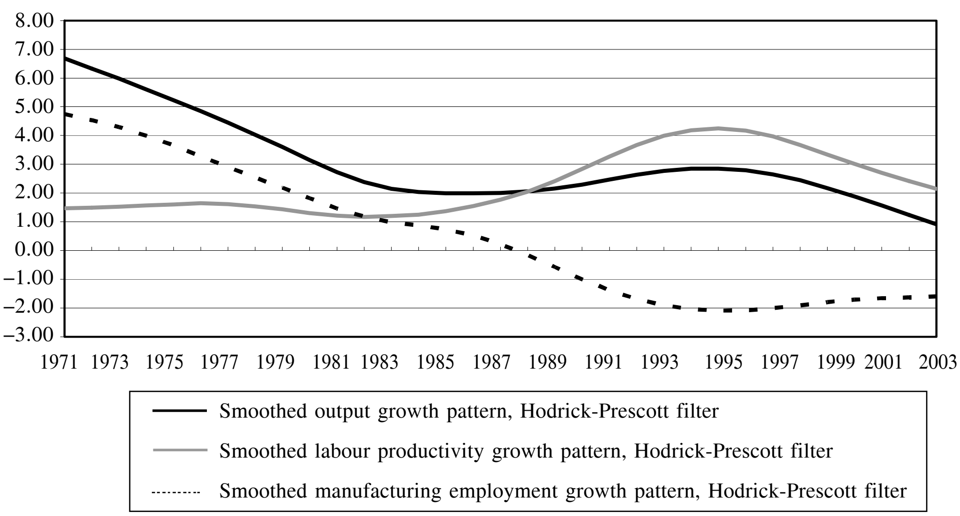
Figure 3 shows the dynamism of output, productivity and employment in the Latin American formal sector over the last three decades. Following a period of low but stable growth, the smoothed growth trend of labour productivity rises sharply, chiefly owing to labour expulsion. It then falls again, but the labour absorption capacity of former times is not recovered.

Meanwhile, the steadily downward trend in output growth is accompanied by a deterioration of employment growth in manufacturing industry, which actually turned negative in the late 1980s. This is unusual in a developing economy. In the Republic of Korea, for example, rising productivity over the last three decades has been accompanied by employment growth in manufacturing industry (Cimoli, Primi and Stumpo, 2004). In the 1950s and 1960s, today's developed countries experienced the same pattern (Kaldor, 1966); only later, when they had reached the technology frontier, did manufacturing employment fall. Besides, the "deindustrialization" typically seen in certain European countries where manufacturing employment has fallen is fundamentally different from the erosion of labour absorption capacity in Latin American industries.

The development of the service sector has changed the global distribution of employment. In the European countries, however, reallocation of the labour factor has not only translated into rising employment in more dynamic emerging activities, but has been accompanied

FIGURE 3

Latin America: Dynamics of output, productivity and employment in the formal sector



Source: Prepared by the authors using data from ECLAC and from the ECLAC Industrial Performance Analysis Program (PADI).

by major programmes of State aid and welfare policies. Latin America, by contrast, has displayed a different pattern, since reallocation of the labour factor has led to higher employment in the lowest-productivity sectors, especially personal and commercial services (Tokman, 1997; ECLAC, 2005; ILO, 2004).

In Latin America, the decline of employment in the formal sector has increased unemployment and informal working (Ros, 2005; IDB, 2003; Pliego, 1997). To reflect this, the model assumes that the informal sector plays a residual role, giving rise to a particular model of "full employment" where:

$$(17) \qquad L = L_f + L_i$$

so that:

$$(18) \qquad 1 = \lambda l_i + (1-\lambda) l_f \qquad 0 \leq \lambda \leq 1$$

According to equation (18), the labour force growth rate l breaks down into formal-sector employment growth and informal-sector employment growth; λ is the share of informal employment in the whole economy. Therefore, since the employment dynamic in the formal sector is already determined, and since growth in the labour force is exogenous, the employment equilibrium rate in the informal sector is easily obtained:

$$(19) \qquad l_{ie} = \frac{l}{\lambda} + \alpha \frac{1-\lambda}{\lambda} \; \frac{1-b}{1-b\beta}$$

This equation means that informal employment rises if $l > (1 - \lambda) l_f$, that is, it is not necessary for l_{fe} to be negative for $l_{ie} > 0$.

It is hazardous to formulate hypotheses for productivity dynamics in the informal sector; however, it is reasonable to think that productivity growth in this sector may be affected by productivity growth in the formal sector. Consequently, it is considered that:

$$(20) \qquad \pi_i = c\,\pi_f \qquad \text{with } 0 \leq c \leq 1$$

Hence:

$$(21) \qquad \pi_{ie} = \frac{c\alpha}{1-b\beta}$$

Equilibrium output growth for the informal sector can thus be obtained from equations (19) and (20) and the usual decomposition of productivity growth:

$$(22) \qquad y_{ie} = \frac{l(1-\beta b) + \alpha\left((1-\lambda)\,(1-b) + \lambda c\right)}{\lambda(1-b\beta)}$$

Higher growth in the labour force induces higher growth in informal output. Likewise, a rise in productivity growth in the formal sector, reflected in a greater α, increases informal output growth, since the surplus labour shed by the formal sector ultimately increases the labour supply available to the informal sector.

The dynamics of the informal sector contribute to the worsening of overall economic performance. If b is insufficiently great, e.g., $b < 1$, then the economy becomes more and more "informalized" in terms of both employment and output. The "informalization" of employment is plain to see from equation (19), while that of output can be observed in the following:

$$23) \qquad y_{ie} - y_{fe} = \frac{l(1-\beta b) + \alpha\left(\lambda(1-c) + (1-b)\right)}{\lambda(1-b\beta)}$$

which is greater than zero.

Economic performance is also adversely affected from the standpoint of equity. In the general case where $c < 1$, the wage gap between the two sectors rises so that:

$$(24) \qquad w_f - w_i = \pi_f \; \frac{1-c}{1+d} \quad > 0$$

where the reduction of d widens the pay difference.[21]

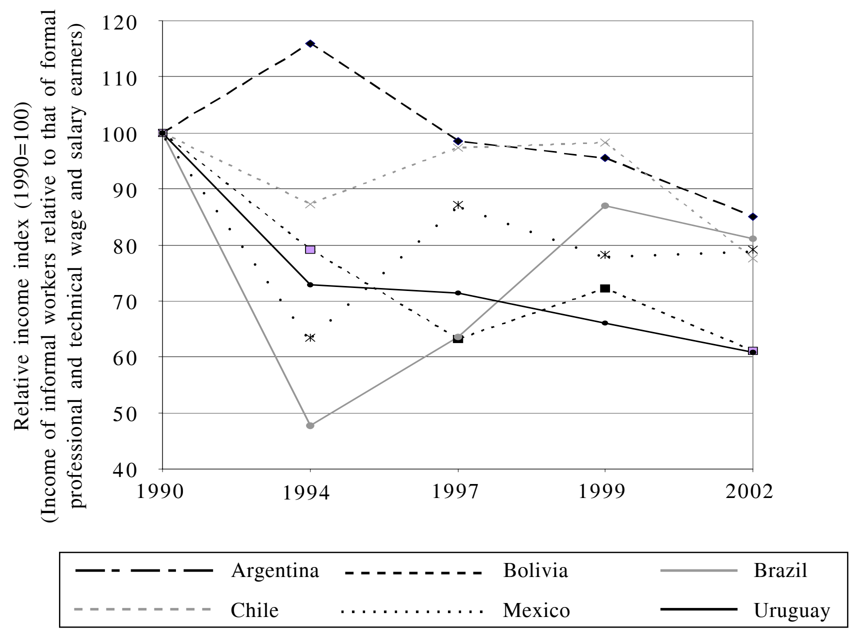
The downward trend in the relative income index for the informal sector as compared to the formal sector confirms the tendency for the pay gap to widen in the countries considered. Between 1990 and 2002, in fact, the income of informal workers in Latin America fell almost uninterruptedly against that of salaried professional and technical workers in the formal private sector. In 2002, the ratio between the average income of informal-sector workers in Latin America and that of these salaried staff in the formal sector was almost a third lower than in 1990 (figure 4).[22] The fact is that although the persistence of informal employment, poverty and inequality are three different structural problems in the region, they are closely interrelated. In the 1990s, almost 60% of the Latin American poor were working in informal activities (Tokman, 1994) and, according to an empirical evaluation by IDB, informal employment accounted for between 10% and 25% of pay inequality in the labour market.

[21] As defined in equation (7) of appendix A, d expresses productivity in the informal sector as a fraction of formal-sector productivity.

[22] This means that informal-sector income fell more rapidly than formal-sector salaries, increasing the inequality between the two.

FIGURE 4

Latin America (six countries): The widening pay gap, 1990-2002[a]



Source: Prepared by the authors from ECLAC (2003).

[a] Figures are ECLAC estimates based on national household surveys. The series represent the index (base year 1990) of the ratio between the average income of urban residents working in low-productivity sectors (i.e., the informal sector) and the average income of professional and technical urban wage and salary earners in the formal private sector.

According to the model, productivity growth can diminish even in the extreme case where productivity rises at the same rate in both sectors ($c = 1$). The more likely case of $c < 1$ is even worse, since the difference in both output growth and productivity levels widens (d decreases). At the limit, the economy will tend to the steady state as follows: for $t \to \infty$, then, $l_{ie} \to l, \lambda \to 1, y_{ie} \to l + c\pi_{fe}$ i.e., the economy tends to become completely informal, with the productivity growth rate reduced to that of the informal sector.

These conclusions are in contrast to those of the standard theory, which expects the informal sector to disappear gradually of its own accord as development and modernization take their course. In fact, according to the model dynamic, a virtuous dynamism that was conducive both to rising formal employment and to output and productivity growth would require structural change[23] to take place in tandem with ever-increasing application of measures to stimulate linkages, disseminate knowledge and train human capital. Failing this, it is possible that an enclave-led form of growth might persist, with a modern, outward-oriented formal sector coexisting with a growing informal sector, with adverse consequences for overall growth. This is just what has been happening in Latin America: modernization has taken place and external trade has increased, but the pattern of specialization and commercialization has favoured the relative expulsion of labour from the formal sector, thus perpetuating the growth and persistence of the informal sector.[24]

[23] Structural change means reorienting the specialization of the formal sector towards more diversified stages or industries with a higher knowledge content.

[24] Carillo and Pugno (2004) explain the persistence of informal employment linked to underdevelopment and also show that policies designed to improve formal-sector results are more useful than policies for legalizing informal activities.

IV

Growth and informality: a comparative statics exercise

Taken together with the relationship between the formal and informal sectors, the demand and productivity regimes define a growth model in which the microeconomic characteristics of the production structure (i.e., its ability to generate and transfer technology and know-how, the pattern of specialization, participation in international trade and the coexistence of a formal sector and an informal one)[25] determine the pattern of overall growth.

In our analytical framework, the characteristics of the production structure act as constraints on export-led growth and, in a vicious circle, the structural weaknesses of the informal sector have a growth-reducing effect. This is why it is affirmed that the Latin American export-led growth model most resembles an enclave model which does not even guarantee high overall growth.

The model sheds light on the structural weaknesses that are hindering export-led growth in Latin America and indicates the constraints on convergence between the region's countries and those at the technology frontier.

As well as macroeconomic stability and human capital formation, what is needed is structural change that allows the production apparatus to be restructured around more complex and technology-intensive sectors, to alter patterns of international specialization while at the same time raising economic growth.

Prebisch (1949), Nurske (1953) and Kuznets (1980) were already arguing that trade liberalization and export promotion strategies would not speed up growth. And indeed, it is possible that trade may not dynamize growth when the domestic market is insufficiently developed. In Latin America, the persistence of informal employment, the lack of complexity and linkages in the production structure and the incentives created by precipitous trade liberalization have affected specialization patterns and the generation and dissemination of technological capabilities in a way that has helped entrench informal activities and thus slow down growth. The weakness of domestic technological efforts and the inability of local actors to take advantage of the spillover effects of technical change have made external demand a determining factor of long-term growth in Latin America.

In the language of the model, these dynamics are expressed by equation (16), which shows, first, that structural change is a crucial driver of growth in output, productivity and, at the same time, employment; and, second, that informality can only be reduced if the pattern of international specialization improves and progress is made towards "high-quality" participation (in terms of sectors, industries and products) in international trade.

Figure 5 illustrates the persistence, and even the strengthening, of structural weaknesses in Latin America. It shows the dynamism of imports in relation to GDP, and of the region's productivity in relation to that of the United States. While importing advanced technologies certainly can help to modernize production processes, it does not automatically lead to the development of endogenous technological capabilities.[26] From the mid-1980s, in fact, the income-elasticity of imports, including capital goods and high-technology inputs, increased to an extraordinary degree, while the productivity gap closed only slightly.[27]

Failure to improve the specialization pattern is preventing the Latin American countries from

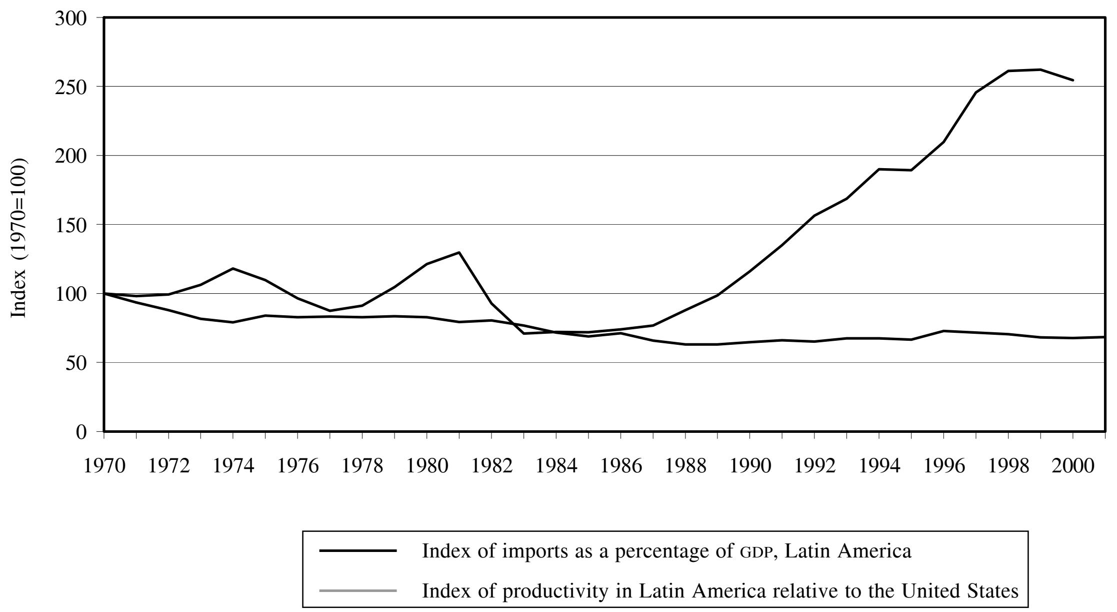
[25] The formal and informal sectors, operating with different institutional, organizational and productive mechanisms, determine both overall productivity and overall growth.

[26] The rise in capital goods imports did not shift the productive specialization pattern towards activities and sectors with a greater knowledge content and higher value-added. Market opening did drive formal-sector restructuring in the Latin American countries, but the effect was to reinforce their specialization in activities with a low technology content and their subordinate role in international production chains (Cimoli, 2005).

[27] In Latin America, the so-called trade multiplier, which is the ratio between the technological gap multiplier (i.e., the productivity growth of the region relative to that of the technology frontier, for which the United States economy is a good proxy) and the income-elasticity of imports, decreased on average from 0.43 to 0.28 after the reforms, thus offsetting the effects of rising exports on output growth (Cimoli, Correa and Primi, 2003).

FIGURE 5

Latin America: Relative productivity and import dynamism



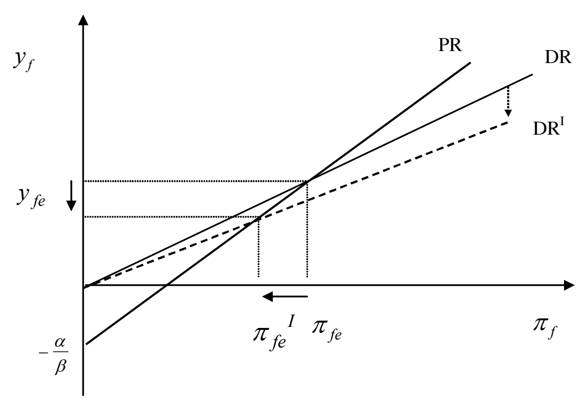
Source: Cimoli, Correa and Primi (2003).

enhancing their competitiveness and increasing their exports, so that the external constraint is worsening and growth is weakening accordingly (Cimoli and Correa, 2005; Ocampo and Martin, 2003). As a result, their economies are developing around an enclave which does not even guarantee a high rate of growth. In a context characterized by a widening gap between the production structure and the technology frontier and by inefficient production, it is possible that liberalization and rising external trade may translate into a greater income-elasticity of imports that counteracts the export dynamic, as happened in Latin America after trade liberalization.

The model can easily capture the effects of a rise in the income-elasticity of imports. In equation (10), b falls as e rises. Thus, as figure 6 illustrates, the DR function rotates clockwise, with the consequence that both y_{fe} and π_{fe} diminish. Equations (12) and (13), however, tell us that the major effect is on y_{fe}. In fact, $\frac{\partial \pi_{fe}}{\partial b} = \beta \frac{\partial y_{fe}}{\partial b}$, so that employment diminishes in the formal sector and expands in the informal sector. Therefore, whole-economy productivity and output worsen because there is a relative expansion of the sector with the lowest productivity level and a widening of the pay gap.

FIGURE 6

Latin America: Decline in the equilibrium growth rates of output and productivity following the rise in the income-elasticity of imports

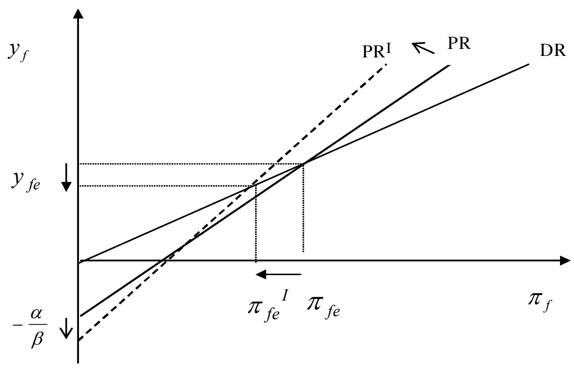


Source: Prepared by the authors.

The model can also capture the effects of the loss of linkages and the reduction in the complexity of local production chains. A reduction of β rotates the PR function anti-clockwise and shifts it downward as in figure 7. The net effect is a reduction in both y_{fe} and π_{fe}. A rise in α shifts the PR function further downwards, with a positive effect on π_{fe} and, to a lesser extent, y_{fe}

FIGURE 7

Latin America: Decline in the equilibrium growth rates of output and productivity with the decline in endogenously generated productivity growth



Source: Prepared by the authors.

(in fact, $\frac{\partial y_{fe}}{\partial \alpha} = b\frac{\partial \pi_{fe}}{\partial \alpha}$). This change in its source explains why productivity growth actually increases in the formal sector rather than declining. In other words, the positive effect of the rise in α on y_{fe} may completely offset the negative effects of the reduction in both b and β on y_{fe}. Appendix B proves that in this case the model still predicts a rise in π_{fe} and hence a reduction in l_{fe}, with all the negative consequences this has for overall economic performance.

V

Conclusions

Structural heterogeneity has long been a constraint on growth in Latin America. The Latin American economies have constantly been held back from converging on those at the technology frontier by the coexistence in the region of a formal sector and an informal sector with different productive and institutional systems.

Structural weaknesses and rising international trade have generated perverse incentives that have favoured enclave-led growth, in which only the formal sector[28] has benefited from increased global trade, and whose benefits have not been transferred to the "rest" of the economy. Formal-sector modernization, furthermore, has been based on incremental innovations and the rationalization of production processes more than on any increase in endogenous technological capabilities (ECLAC, 2004b); again, productivity growth has been largely due to the expulsion of labour, which has tended to entrench informality.

To alleviate the external constraints on growth, there is a need for more complex and diversified production structures with greater dissemination of knowledge and more linkages, and for a shift in the specialization pattern towards more knowledge-intensive products and processes. The fact is that efforts to enhance forward and backward linkages in Latin America will not make inroads into informal employment unless the production structure is transformed and the pattern of international specialization is reoriented in the Latin American countries.

To raise its growth rate and grow more, the region needs to move on from its current situation by orienting itself towards an "inclusive" export-led growth model and increasing its labour absorption capacity. Latin America should transform its production structure and reposition itself in international markets, leaving behind it the persistent problem of informality and thus laying the groundwork for convergence with the technology frontier.[29]

[28] Actually, only certain enclaves within the formal sector.

[29] In other words, "high-quality" participation in international trade is a prerequisite for the kind of virtuous growth pattern that can bring down informal employment while raising output, productivity and employment in the formal sector.

APPENDIX A

The static part of the model

A traditional 2 x 2 model is taken, with $Y, = Y_f, + Y_i$.

The output of the economy, Y, includes two types of products: those of the formal sector, Y_f, which use imported inputs and are then exported, and those of the informal sector, Y_i, all of which go to the domestic market.

The formal sector basically works with a simple additive technology that uses labour (L_f) multiplied by a variable labour effort (h) and imported inputs (M_f).[30]

(1) $$Y_f = \Pi_f L_f h + \eta M_f \qquad \Pi_f > 0, \eta > 0$$

Π_f and η are the technological parameters firms have to work with, which change in the long run. In particular, technical progress usually increases Π_f, but it may also require labour substitution, involving a reduction in η.

The extension of (1) to variable labour effort is typical of the formal sector. According to the efficiency wage theory, the labour effort will be greater in the formal sector than in the informal sector. Labour effort is assumed to be a positive (S-shaped) function of wages in the formal sector, and to be deterred by the lower wages of the informal sector. Equation (2) specifies labour effort:

(2) $$h = \ln q \frac{W_f - W_i}{\Pi_f}$$

All firms in the formal sector maximize profits P_f by controlling wages. Some barrier to entry allows positive profits. Maximization requires that $\frac{\partial P_f}{\partial W_f} = 0$, that is:

(3) $$\frac{\partial}{\partial W_f}\left(Y_f - L_f W_f - p\eta M_f\right) = 0$$

where p is the international price of imported inputs in domestic currency. Profit maximization thus yields the following results once (1) has been substituted into (3):

(4) $$W_f = \Pi_f + W_i$$

(5) $$h = \ln q$$

Substituting (4) into (2) yields equation (5). This indicates that when productivity increases because of technical progress (and the substitution of labour) and the wage gap between the two sectors widens, labour effort remains unchanged.

Therefore, firms are able to determine a fixed level of effort, which is greater than 1 if q is greater than the Neperian number.[31] Wages in the formal sector are determined by labour productivity and by wages in the informal sector, which are lower.[32] The labour market is thus segmented. Since workers contend for formal jobs, firms in the formal sector have first pick of the workforce. The demand for formal-sector output will determine both the employment and import levels required by the sector, while the informal sector absorbs the residual supply.

In the informal sector, output is produced with constant returns to labour and unitary effort:

(6) $$Y_i = \Pi_i L_i$$

An important assumption for the model is that:

(7) $$\Pi_i = d\Pi_f \qquad \text{with } 0 < d < 1$$

Profit maximization yields:

(8) $$W_i = \Pi_i$$

Therefore, the informal sector is typically characterized by low productivity. Wages are determined in this sector and hence in the formal one through equation (4).

[30] For simplicity's sake, the use of local inputs is not included in the specification of the formal sector. The assumption is consistent with the model objective, which is to show the structural differences between the formal sector and the informal sector. Indeed, the main difference between the two sectors, apart from the difference in productivity, is that the former is outward-oriented and the latter inward-oriented, which justifies the specification of equation (1).

[31] Note that the parameter m must be sufficiently greater than the Neperian number for there to be at least positive profits, i.e., $P_f = L_f (\Pi_f (\ln q\text{-}1) - W_i) + (1\text{-}p)\, \eta\, M_f$.

[32] The size and number of firms remain indeterminate.

APPENDIX B

The demand regime

The theoretical background to the demand regime (Setterfield and Cornwall, 2002) goes back to the concept of the foreign trade multiplier originally developed by Harrod (1933), Kaldor (1966 and 1975) and Thirlwall (1979), according to which a rising income-elasticity of imports reduces the positive effects of export growth on income growth. The versions introduced later by Cimoli, Dosi and Soete (1986) and Cimoli (1994) supplement the original expression with the concept of the technological gap multiplier. In effect, income growth is affected not only by export growth and the income-elasticity of imports but also by the ratio between the productivity growth rate of the export-oriented formal sector and that of the technology frontier, i.e., the technological gap multiplier: $\Psi = \frac{\pi_f}{\pi^*}$.

The demand regime is derived from a situation of equilibrium in the trade balance, expressed by equation (i):

(i) $$M = E$$

where M represents domestic demand for imports and E indicates exports, both expressed in the same monetary unit.

According to standard demand theory, domestic demand for imports is a multiplicative function of national income and is determined by the following expression:

(ii) $$M = Y_f^{\varepsilon}$$

where ε is the income-elasticity of imports and Y_f represents domestic income generated in the formal sector.

Correspondingly, exports are a multiplicative function of external income Y^* and are measured by equation (iii):

(iii) $$E = Y^{*\tau\psi}$$

where τ is the income-elasticity of exports and Ψ is the technological gap multiplier.

When equation (i) holds, its dynamic version, expressed by equation (iv), stands as well:

(iv) $$m = e$$

where m is the import growth rate and e is the export growth rate. By differentiating equations (ii) and (iii) and substituting them into equation (iv), therefore, we obtain equation (v), which expresses the dynamic version of the trade balance equilibrium condition:

(v) $$\varepsilon y_f = \tau \psi y^*$$

Assuming that x is the export growth explained by foreign income growth, $X = \tau y^*$, and substituting equation (iv) into equation (v) while bearing in mind that, $b = \frac{x}{\varepsilon \pi^*}$ we obtain the following multiplicative expression, which is just the same as the demand regime specified by equation (10):

(vi) $$y_f = \frac{\Psi}{\varepsilon} x = \frac{\pi_f}{\varepsilon \pi^*} x = b \pi_f$$

APPENDIX C

The productivity effect of an increase in autonomous effort

To prove that α contemporaneous rise in a and reductions in both b and β can yield a constant y_{fe} and a rise in π_{fe}, let us proceed in two steps. Firstly, let us prove that a contemporaneous rise in α and reduction of b can yield a constant y_{fe} and a rise in π_{fe}. From the condition of zero net effect on y_{fe}, i.e., $\frac{\partial y_{fe}}{\partial \alpha}\Delta\alpha + \frac{\partial y_{fe}}{\partial b}\Delta b = 0$, let us derive that $\frac{\Delta b}{\Delta \alpha} = -b\frac{1-b\beta}{\alpha} < 0$. Then, let us derive the direct and indirect changes in π_{fe} for a unitary $\Delta\alpha$, i.e.,

$$d\pi_{fe} \frac{\partial \pi_{fe}}{\partial \alpha} + \frac{\partial \pi_{fe}}{\partial b}\Delta b = \frac{\partial \pi_{fe}}{\partial \alpha} - \frac{\partial \pi_{fe}}{\partial b} b\frac{1-b\beta}{\alpha} > 0.$$

Secondly, let us prove that a contemporaneous rise in α and reduction of β can yield constant y_{fe} and π_{fe}. Using an analogous procedure, let us derive $\frac{\Delta\beta}{\Delta\alpha} = b\frac{1-b\beta}{\beta\alpha}$ and then $d\pi_{fe} = \frac{\partial \pi_{fe}}{\partial \alpha} + \frac{\partial \pi_{fe}}{\partial \beta}\Delta\beta = 0$. Therefore, a rise in α and opportune reductions of b and β can yield a constant y_{fe} and a rise in π_{fe}.

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CEPAL REVIEW 88 • APRIL 2006

The Argentine labour market in a financially globalized world

Mario Damill and Roberto Frenkel

Argentina's experience in recent decades as regards employment generation and wages has been very disappointing, and has had clear consequences for income distribution and other social indicators. This study examines the evolution of the labour market, with special emphasis on the 1990s, and also addresses the notable changes that have been taking place in recent years after the crisis of the convertibility regime. In general terms, it finds that the evolution observed in the labour market and income distribution is very closely linked with macroeconomic performance, both in previous phases and in the recent recovery stage. It examines in particular the negative effects of the experiences of trade openness and exchange rate appreciation in the late 1970s and the 1990s, which are in stark contrast with the present situation, especially in terms of employment generation.

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I

Introduction

For a number of decades, the Argentine economy has been turning in a very unsatisfactory performance in terms of employment generation, as regards both the quantity and the quality of the jobs generated. There has also been a long-term downward trend in average real wages and a sustained deterioration in income distribution.

Our general argument is that these features of the labour market and income distribution are closely linked with macroeconomic performance. Since the mid-1970s, in particular –except for a few relatively brief periods– labour conditions have been adversely affected by a number of macroeconomic factors: instability of the gross domestic product (GDP), its low long-term growth, high rates of inflation, frequent oscillations in relative prices associated with successive attempts at stabilization and their failure, and a prolonged period of exchange rate appreciation. Special mention should be made of the unfavourable effects on employment of the experiences of trade openness accompanied by exchange rate appreciation in the late 1970s and the 1990s, as well as the crises through which the country's economy has passed.

The features of the country's macroeconomic performance in this period were the result of the combination of reform processes, stabilization policies, and major changes in the international context. The reforms and macroeconomic policies adopted defined the particular way in which the Argentine economy fitted in with the new external financial framework during the phase known as the second financial globalization. In short, the above-mentioned tendencies of employment and income distribution are associated with the international integration path followed by the country from the mid-1970s.

Broadly speaking, four main phases may be distinguished in the macroeconomic history of this period. The first stage –one of deregulation and trade and financial openness– extended from 1977 to 1982. It ended in an exchange-rate, financial and debt crisis and was followed by the closure of external financial markets or the rationing of international credit, from 1982 to 1990. Then came a new phase of deregulation and trade and financial openness, corresponding to the period in which the convertibility regime was in force, between 1991 and 2001. This phase too ended in crisis and payments defaults. Finally came the present period of economic recovery. To sum up, the two periods of trade and financial openness ended in serious banking, exchange-rate and debt crises, while the intervening stage of credit rationing ended in the episodes of hyperinflation of 1989 and 1990.

In the present paper we will concentrate on analysing what happened from the early 1990s on, with special attention to the processes associated with macroeconomic dynamics under the convertibility regime and their effects on the labour market. We will also examine the main features of the present phase, subsequent to the 2001-2002 crisis. It should be noted, however, that some of the most important broad features of macroeconomic behaviour in the 1990s are similar to what was observed in the previous period of openness in the late 1970s. Both these stages may be interpreted on the basis of a common model, as is also true of various comparable experiences in other economies, especially in Latin America. This common model, together with the comparative analysis of the experiences in question, has been developed elsewhere, so we will not describe it in detail here.[1] With this interpretative framework as the background, the following section of this paper (section II) presents the main events in the Argentine macroeconomic field during the 1990s, including the final crisis of the convertibility plan and a description of the main features of the economic recovery subsequent to that crisis.

Section III contains an analysis of the quantitative evidence on the impact of the country's macroeconomic performance on employment, unemployment and wages, with special emphasis on the 1991-2002 period. In particular, this section analyses in some detail the effects to be expected from the combination of an

☐ A more extensive version of this paper was submitted at the International Conference on Globalization and National Development: Towards Greater Coherence between Economic and Labour Policies (Buenos Aires, August 2005), organized by the International Labour Organization.

[1] See for example Frenkel (2003a and 2003b) and Damill, Frenkel and Rapetti (2005).

appreciated exchange rate and trade openness. It then describes the evolution of aggregate employment, underemployment and unemployment in the 1990s, going on to focus on the behaviour of the same variables in the recent recovery stage. A quantitative model is given for estimating the aggregate impact of the evolution of economic activity and relative prices on employment, and an analysis is presented which covers both the convertibility period and the recovery phase. The structure of the contraction in employment in the 1990s is described, showing that it originated mainly in the tradeables sectors. Finally, the analysis is completed with a study of the evolution of income and the estimation of wage curves showing real wages as a function of unemployment rates in both the convertibility period and the recovery phase.

II

Argentine macroeconomic dynamics in the 1990s

1. Performance under the convertibility regime

During the last third of the twentieth century, a process known as the second financial globalization took place in the world. In this new stage of international financial evolution, various countries in Latin America and other regions went through external and financial crises which had dramatic effects in real terms. These episodes generally involved high economic and social costs and setbacks in growth. The crises in Mexico (1994-1995), Argentina (1995), Brazil (1998-1999) and once again Argentina (2001-2002) occurred in the Latin American countries which had received the biggest capital flows in the previous boom periods. These countries were also the biggest economies and the leading “emerging markets” of the region.

In the various national experiences in question, the application of reforms such as trade openness and greater openness and liberalization of the capital account –together with privatization processes, fiscal reforms and deregulation measures in other markets– was combined with anti-inflationary macroeconomic policies in which fixed or virtually fixed exchange rates played a crucial role. Thus, Mexico applied a programme of this type in 1988, Argentina in 1991 and Brazil in 1994.

A summary examination of these cases allows us to identify a set of common features of the institutional and economic policy contexts in which the crises took place: i) the nominal exchange rate was fixed or virtually fixed; ii) there was an appreciated real exchange rate; iii) there were practically no barriers to the free movement of capital; iv) capital inflows in the preceding boom period were very large in comparison with the size of the existing national money and capital markets, and v) regulation of the national financial systems in the boom period was relatively weak and permissive.

In all cases, the experiences in question show that, in addition to these characteristics, there was a cyclical macroeconomic dynamic, with an initial expansionary phase, followed by a period of stagnation or recession, growing financial and external fragility and, finally, financial and exchange-rate crisis.[2]

Under the stabilization scheme with an exchange-rate anchor and trade and financial openness adopted, together with the convertibility plan, by Argentina in the 1990s, the features referred to above, such as the cyclical dynamic, were also present. The openness and expansion cycle, followed by an increase in external financial fragility, contraction and crisis, was experienced by that country twice in the decade, however. The first time was between 1990 and 1995 (the year in which the economy was stalled by the spillover effects of the Mexican crisis), while the second time was between 1995 and 2001 (figure 1). The first of these cycles did not result in an exchange-rate crisis, but it did cause a recession and a financial crisis.

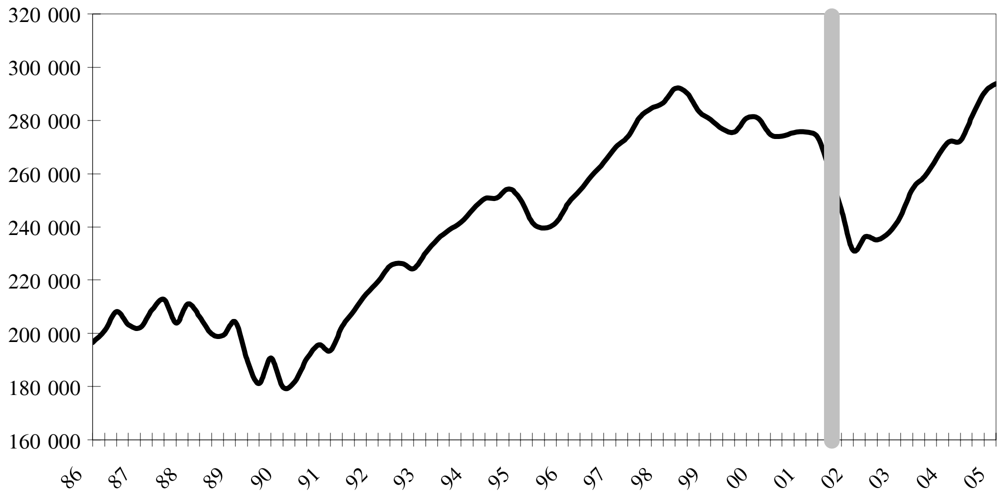
The various positive changes which took place in the international financial context had a strong impact at the domestic level in the early part of the period. International interest rates fell sharply as from 1989, while access to external finance was restored. In 1991 capital inflows began to reach substantial levels. As well as expulsion factors (especially the fall in interest rates in the developed world), which explained much of the

[2] Summary descriptions of the cycle are given, for example, in Frenkel (2003a and 2003b), Damill, Frenkel and Maurizio (2003) and Damill and Frenkel (2005). See also Taylor (1998).

FIGURE 1

Argentina: Gross Domestic Product, 1991-2005[a]

(At constant 1993 prices)



Source: Prepared by the authors on the basis of figures from the Ministry of the Economy and Production.

[a] De-seasonalized quarterly data.

flow of capital to emerging markets, domestic "attraction" factors were also important: in the case of Argentina, special mention may be made in this respect of the privatization process begun in 1990, financial liberalization, and the application of the stabilization programme. Thus, in the early years of the decade net inflows of funds exceeded the current account deficit, making possible a rapid and substantial accumulation of international reserves, the initial level of which was very low. The accumulation of reserves fed the increase in the supply of money and credit, and this, together with the decline in both external and domestic interest rates, led to rapid growth of aggregate demand and GDP. The increase in GDP, in its turn, affected the balance of payments, since it stimulated imports and thereby contributed to the current account deficit. Trade openness and the appreciation of the exchange rate acted in the same direction.

The growth led by capital inflows continued up to 1994. In that year, however, there was a rise in international interest rates (following the Federal Reserve's decision to raise its discount rates as from February). This began to affect the inflow of funds negatively and, because of the growing current account deficit, the foreign exchange reserves stopped growing.

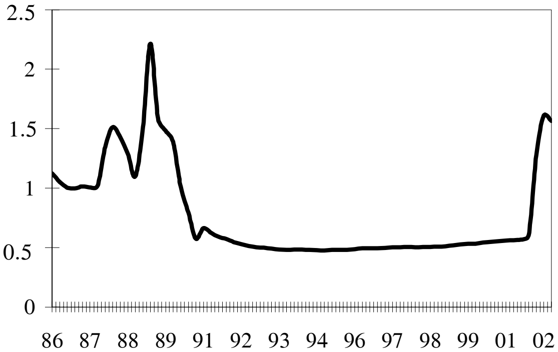
It may be noted that, in this first stage, the stabilization programme was very effective in checking inflation. Following its adoption, there was an immediate slackening in price rises. In the case of internationally tradeable goods, for which the wholesale price index is a good approximate indicator, the fixing of the exchange rate had a marked impact. Inflation at the wholesale level went down immediately to levels of the order of 1% per month and continued to go down. This index registered total variation of 12.5% from the beginning of the plan up to December 1994, which is equivalent to a little over 3% in annualized terms and is in line with international inflation as measured, for example, by the United States consumer price index.

The Argentine consumer price index (CPI), in contrast, rose by 58.5% over the same period. Although in this case, too, there was a sharp fall in the rate of inflation, the residual inflation built up in the first three years was very substantial. This is explained by the greater weight of non-tradeable goods and services in the calculation of the CPI, and therefore reflects the change in relative prices which took place over the period. The divergence between the variations of these two price indexes disappeared towards the end of 1994, however. From that time, and up to the final crisis of the macroeconomic regime in December 2001, inflation rates always tended to be very close to zero, with a predominance of slight negative figures.

Figure 2 and table 1 give information on the evolution of the real exchange rate. It is important to note that this variable, which had reached

FIGURE 2

Argentina: Real exchange rate,[a] 1986-2002
(Second half of 1986 = 1)



Source: Prepared by the authors on the basis of figures from the National Institute of Statistics and Censuses (INDEC) and the Central Bank.

[a] Nominal exchange rate multiplied by the United States consumer price index (CPI), over the local CPI.

TABLE 1

Argentina: Average real exchange rate in different periods
(Second half of 1986 = 1)

Period	Real exchange rate
1986-1988	1.16
1986-1990	1.22
1990:4-1991:1[a]	0.62
1991:2-1994:4[a]	0.52
1995-2001	0.52
2002	1.48

Source: Prepared by the authors on the basis of data from INDEC and the Central Bank.

[a] Quarters.

extraordinarily high levels during the exchange-rate stampede which set off the crises of hyperinflation in 1989 and 1990, dropped almost vertically in the course of the latter year, that is to say, before the launching of the convertibility plan.

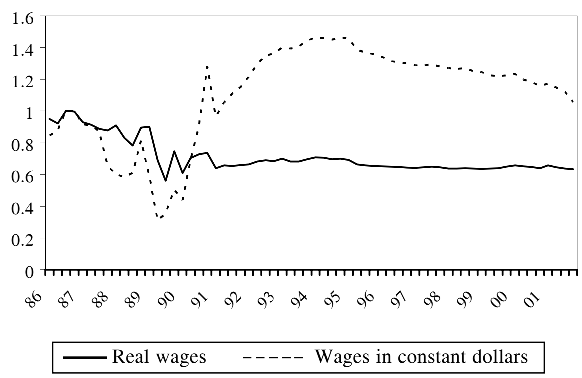
As may be seen from table 1, already in the period immediately before the launching of the stabilization plan, real parity was almost 50% below its average level in the 1986-1990 period. Compared with this decline, that which was observed from the second quarter of 1991 onwards may be considered of only second order. This was followed by a long period of stability in which the variations in real parity were very small, until the monetary regime broke down in December 2001.

Figure 3 and table 2 give data on wages in dollars and average real dollars in the manufacturing sector. Once again, in the case of wages in dollars, the drastic change at the beginning of the period should be noted. The increase in wages measured in this currency is over 50% when the level in the period before the launching of the plan is compared with the average for 1986-1990. Here, too, the subsequent variations may be considered as being of second order.

Real wages in manufacturing, in contrast, behaved very differently, which also reflected the process of exchange-rate appreciation. As the prices of non-tradeable goods and services measured in dollars rose considerably, and these goods and services weighed heavily in the CPI, wages deflated by this index only rose slightly at the beginning of the stabilization plan, after having fallen in the preceding months. After a

FIGURE 3

Argentina: Average real wages in manufacturing and average wage in constant purchasing power dollars, 1986-2001



Source: Prepared by the authors on the basis of data from INDEC.

moderate rise in the first years of convertibility, average real wages in manufacturing showed a slight downward trend during the second half of the decade.

During the expansionary phase which lasted from 1990 to 1994, the economy became increasingly vulnerable to unfavourable external shocks. The current account deficit tended to rise, while at the same time external indebtedness was increasing. The dependence on inflows of funds was thus further increased. In other words, the macroeconomic scheme became more vulnerable to changes that could more or less abruptly affect the availability of external finance. This source of vulnerability became more evident in the case of Argentina because the regime involved complete liberalization of capital flows.

The rise in international interest rates in 1994, which was already mentioned earlier, and its consequences for the inflow of capital and the inherent

TABLE 2

Argentina: Average wages in manufacturing at different periods
(Second half of 1986 = 100)

Period	1986-1988	1986-1990	1990:4-1991:1	1991:2-1999:4	1995-2001
Real wages[a]	90.8	82.9	68.8	68.4	64.8
Wages in dollars[b]	80.6	73.9	112.3	133.4	125.8

Source: Prepared by the authors on the basis of data from INDEC.

[a] Average wage deflated by CPI.

[b] Average wage in constant purchasing power dollars (deflated by the United States consumer price index).

mechanics of the convertibility regime could of themselves have led to a contractive phase. At the end of that year, however, Mexico suffered a run on the peso which ended in heavy depreciation. The effects immediately spread to Argentina. Consequently, instead of the country registering an endogenous adjustment in line with the typical workings of a currency board regime, the external shock led to a massive and rapid outflow of funds early in 1995, with a parallel very marked rise in domestic interest rates. The stock of foreign exchange reserves went down abruptly, and there was a corresponding contraction in liquidity. Aggregate demand behaved similarly. In this phase, the unemployment rate (which had actually already begun to show an upward trend two years earlier, when the economy was still expanding very strongly) rose substantially and from then on always remained at historically very high levels.

Nevertheless, the recession in the middle of the decade was very short. A powerful set of external and domestic financial support measures, arranged with the coordination of the International Monetary Fund (IMF), made it possible to quickly change the negative tone of expectations. In addition, by various means and in spite of the limitations imposed by the convertibility rule, the government carried out intensive monetary activity designed to shore up the banks and thus stop the financial crisis from deepening.

Thanks to the favourable effects of the financial support from the exterior, it was possible to keep the monetary regime in being, and towards the end of 1995 a new spell of expansion was beginning. The monetary mechanism behind this recovery was the same one used in the early years of the 1990s. Access to external funds was recovered; the inflow of capital began to exceed the current account deficit (which had gone down as a result of the recession), and the foreign exchange reserves recovered once again, as did the supplies of money and credit. The elements of the cyclical dynamic were again in motion.

This new expansionary phase had similar features to the first such phase, but it was to be shorter. The risk premium went up in mid-1997, after the Thai devaluation, and growth slackened. The Russian crisis in 1998, which also had a very strong impact on Brazil, brought the period of expansion to an end. Inflows of funds declined from then on, and the accumulation of reserves slowed, and then became negative somewhat later. As a result, a phase contraction of GDP began in mid-1998, culminating in the collapse of 2001-2002, in which, among many other events, there was the violent depreciation of the peso already referred to earlier, and the government began to default on a large part of its external and domestic financial commitments.

The plot of the macroeconomic story of the late 1990s is quite simple. To begin with, the unfavourable turn in the external financial situation which took place in 1997-1998, after the Southeast Asian and Russian crises, found Argentina with a high and growing current account deficit, an over-appreciated currency, and an evident shortage of policy instruments for dealing with this set of problems, because of the rigidity of the macroeconomic scheme adopted. Not surprisingly, in these conditions the country risk premium rose sharply and remained so, while access to external funds became more and more problematical. The subsequent increase in the debt interest burden had a negative impact above all on debtors, including of course the public sector.

In view of the lack of other instruments, the government responded to this situation with restrictive fiscal policies. The official story regarding this approach was usually as follows: fiscal discipline would restore confidence in the public sector's capacity to pay, so that the risk premium on the sovereign debt would go down, leading to a decline in domestic interest rates. Domestic demand for goods and services would therefore recover, bringing the economy out of its recessive slump. Lower interest rates and a higher GDP would also help, in turn, to balance the public accounts, which would also help to restore confidence, thereby creating a virtuous circle.

The macroeconomic history of the last years of the 1990s is the story of the failure of this view of events. In spite of the perceptible adjustment in the public sector's primary result in those years, it was not possible to reopen credit channels. Moreover, the tax rises and cuts in public expenditure further strengthened the recessionary trends, thus helping to confirm the negative expectations which were impeding the longed-for decline in the country risk premium.

Fiscal policy alone was obviously powerless to offset the heavy macroeconomic imbalances whose roots lay elsewhere: in effect, in the external sector. Under this self-destructive fiscal policy approach, the economy was trapped in a vicious circle for several years, thus suffering the longest recession since the First World War.[3]

2. The macroeconomic situation after the cessation of payments and devaluation

After three years of recession, economic activity suffered a further abrupt fall as from mid-2001. The massive flight to external assets that took place in the second half of that year precipitated the collapse of the convertibility regime and culminated in payments defaults and devaluation of the peso. The sharp decline in the foreign exchange reserves suffered in the course of the year rapidly put a squeeze on liquidity. After the imposition of a series of restrictions on the withdrawal of bank deposits by the public (the so-called "corralito"), there was a veritable interruption in the chain of payments. The GDP and employment went the same way as the violent contraction in reserves and liquidity. Social indicators such as unemployment rates and indices of poverty and indigence. which had already deteriorated considerably in the course of the 1990s, suffered a further serious impairment, thereby also heightening the social tensions and political crisis which put an end to the ruling government (the coalition administration named "Alianza"; Damill, Frenkel and Maurizio, 2003).

a) *The economic recovery*

The near-vertical drop in the product and employment continued after the breakdown of convertibility, but only for a very short time. Thus, in contradiction to most opinions and beliefs, including those of various IMF officials, the traumatic political and economic episodes which put an end to the convertibility regime were not followed by an even deeper depression, but instead by an extraordinarily rapid recovery, which began only three months or so after the events described.

Figure 1 above shows the V-shaped path formed by the phase of economic collapse in the last quarters of convertibility and the subsequent rapid recovery. As we just noted, the recovery of GDP began very shortly after the exchange-rate depreciation which marked the end of a decade of convertibility (some three months after, as may be seen from the monthly economic activity indicators available). The recovery was sparked off precisely by the abrupt change in relative prices in favour of the tradeable goods sectors. Initially, the impulse came from the substitution of imported goods with locally-produced articles.

It is worth noting that the start of the new phase began to be perceptible when the country was still sunk in a situation of marked economic instability and political uncertainty, and service payments on part of the public debt were still interrupted.[4] In other words, the "rebound" took place in spite of that extremely complicated initial situation and the negative effects that the currency devaluation had at various levels.

In addition to the favourable effects of the change in relative prices, the merit for the rapid economic recovery following the crisis is also due to a set of policies which, notwithstanding the errors and the stop-and-go actions sometimes observed, were generally aimed at recovering the basic macroeconomic balances. It is noteworthy that several of the policies which played very important roles in this stage had to face the opposition of the IMF. Among these, mention may be made of the re-imposition of exchange controls (which obliged exporters to change a large part of the foreign exchange receipts from international trade on the local market and limited outflows of funds on the capital account); the establishment of export duties (retentions), which enabled the government to share in the favourable effect of the devaluation on the income of the producers of tradeable goods (thus greatly aiding in the restoration of fiscal balance) and softened the impact on domestic prices and, ultimately, real wages; a flexible monetary policy which made it possible, on the one hand, to help

[3] The role of fiscal policy in the convertibility crisis is dealt with and discussed in, for example, Damill, Frenkel and Juvenal (2003) and Damill, Frenkel and Rapetti (2005).

[4] The exchange rate rose rapidly when the initial devaluation which had brought parity to 1.40 pesos per dollar gave way to a currency float; the rises in parity dragged nominal prices with them, and the financial system was in the midst of a profound crisis.

the banks in the crisis phase and, on the other, to satisfy the growing demand for money, thus supporting the recovery process; and an exchange policy which sought to avoid appreciation of the peso through intervention by the Central Bank (and later also by the National Treasury, with fiscal resources) when supply began to exceed demand in the foreign exchange market.

The IMF insisted on the free floating of the peso, and the government did indeed adopt this system for a short time. Once the float was in place, however, the exchange rate shot up and reached levels close to four pesos per dollar, in a context of expectations of much higher increases. The re-imposition of exchange controls was essential in order to burst the exchange-rate bubble. By forcing exporters to change foreign exchange on the local market and limiting outflows of funds, the government managed to stabilize the nominal exchange rate by mid-2002.

When there began to be a perception that this situation could last, the demand for pesos began to settle down and the foreign exchange market registered an excess of supply. The bursting of the foreign exchange bubble decisively aided in containing price rises. Similar effects were secured by, on the one hand, the freezing of public utility rates[5] and, on the other, the very high rates of unemployment, which kept down nominal wages in the private sector. All these factors made possible a rapid decline in inflation as early as the second half of 2002.

b) *The main features of the recovery phase*

The recovery in GDP growth which began in the first half of 2002 went through a brief initial phase in which global demand barely increased, while all the components of domestic spending (private consumption, public consumption and investment) continued to contract, as they had done throughout the prior depression, albeit more slowly. It was therefore not domestic expenditure which stopped the decline in the level of activity. The factors which favoured expansion were above all the international trade variables: exports and imports, and especially the latter. Demand began to be satisfied to a larger extent with domestically produced goods, and this import substitution benefited the manufacturing sector in particular. After this short initial stage, however, the source of economic growth clearly shifted to the components of domestic demand, especially investment (which grew at an annualized rate of nearly 40% between 2002 and 2004) and private consumption.

The favourable external environment is often cited as one of the important elements behind economic recovery. Indeed, in some studies the bulk of the credit for recovery is attributed to a set of "exogenous" positive factors. According to those studies, this was so even though the economic policies applied were considered to be riddled with errors from that standpoint: lack of planning, excessive interventionism, the use of unsuitable instruments (such as taxes that cause distortions), delays in the implementation of "outstanding reforms", etc. Although the impact of external factors (especially the high prices of some commodities) has been undeniable, at least until recently, the fact that the buoyancy of growth was due substantially to domestic demand factors takes away the validity of that interpretation.

It should also be noted that the recovery of consumption and investment took place in a context of marked rationing of credit, both external and domestic. Investment was apparently fed by the bigger retained profits of enterprises and producers, although it was also certainly helped by the "wealth effect" due to the considerable holdings of foreign assets of the resident private sector. These assets, which today stand at around US$ 125 billion, rose in value as a result of the exchange-rate depreciation, whether measured in pesos or in comparison with domestic assets such as real estate and land. This same factor was also undoubtedly one of those behind the recovery of private consumption expenditure.

[5] Many of these rates were dollarized and were adjusted in line with United States inflation, as laid down in the contracts signed when the enterprises in question were privatized.

III

The effects of macroeconomic evolution on employment and wages

1. The consequences of the processes of greater openness plus exchange-rate appreciation

The features of the macroeconomic evolution in Argentina described above were paralleled by developments in the labour market. The initial achievements of the stabilization programme and reforms of the 1990s had positive effects in terms of higher levels of activity and lower inflation rates. On the one hand, greater economic activity meant greater demand for labour, while on the other, the decline in inflation favourably affected the purchasing power of wages. In more general terms, that decline reduced the impact of the "inflation tax", which hit those with the lowest wages hardest.

These consequences are typical of programmes of this type, at least in their initial phase. Other effects of such programmes are often of a negative nature, however. Privatization processes are often followed or preceded by business rationalization measures which involve substantial staff cuts. Adjustments in the expenditure of national, provincial and municipal levels of government have a similar effect, usually involving the reduction of employment and wages. These negative effects on employment and wages are a "once only" phenomenon.

The joint effects of trade openness and exchange-rate appreciation, for their part, call for special consideration, since they have lasting adverse consequences for employment in the production of tradeable goods, especially in the manufacturing sector.

The policy of reducing tariff and non-tariff protection is aimed at increasing the efficiency and productivity of the tradeables sector, through greater competition in the domestic market for imported goods and by giving local firms access to cheaper and higher-quality inputs and capital goods. At all events, trade openness involves the displacement of firms and workers in the less efficient areas of the tradeables sector. In a simple version of this theory, these negative effects should be offset by the simultaneous creation of employment in activities which are made more competitive through increased productivity. In more complex versions, however, it is acknowledged that there may be a more or less long period of lower employment and adverse distributive effects, which must be relieved through public policies. In addition to this, the fact is that in Argentina, as in other Latin American countries in the 1990s, the greater trade openness was accompanied by exchange-rate appreciation.[6] This factor accentuated the loss of competitiveness of the existing industries and hindered the emergence of new export or import substitution activities, thus aggravating the adverse effects on employment.

All these effects, both positive and negative, were observed to a greater or less extent in Argentina and in other economies of the region during the 1990s. The extent to which they occurred determined the direction and magnitude of the aggregate impact in each case. The evolution of employment and income distribution over time also depended on the different speeds of the processes in question. A very significant case, because of the relative importance of the countries involved, is that of the dynamics generated by shock stabilization processes with an exchange rate anchor which also more or less simultaneously included trade openness, privatization, and fiscal adjustment. In keeping with the cyclical macroeconomic dynamics described above, there is usually also a cyclical evolution of employment and of the lowest incomes, with a first upward phase in which the positive effects of reactivation and the fall in inflation predominate, and a second downward phase in which these initial effects tend to weaken and there is predominance, in particular, of the persistent consequences of joint trade openness and exchange-rate appreciation.

[6] These circumstances are in contradiction with conventional recommendations on the macroeconomic policies that should accompany trade openness. Greater openness means less protection for local activities. Consequently, given the real exchange rate, this would bring about an increase in the trade deficit. In order to eliminate this unwanted effect, conventional theory on trade openness recommends that this should be accompanied by a depreciation in real terms.

The above-mentioned employment cycle is clearly observable in the case of Argentina. As we shall see in more detail in the following section, the aggregate employment rate tended to rise between the launching of the convertibility programme (1991) and 1993, subsequently going down steadily and standing at the end of 1996 well below the 1990 employment rate. The contraction mainly affected the jobs of male heads of household working over 35 hours per week, and was concentrated in employment in manufacturing. Although the privatization operations and the fiscal adjustment of the provinces had negative effects on employment, the heaviest negative impact came from the restructuring and concentration of activities in the production of tradeable goods caused by trade openness and exchange-rate appreciation.

The importance of the effects of openness with exchange-rate appreciation make this topic worthy of being developed in greater depth. The behaviour of the demand for labour generated by industrial production may be broken down into three components. First, there is the positive component due to the growth of global demand (domestic demand plus exports). The greater the increase in demand, the greater will be its effect on industrial production and employment in that sector. Second, given the growth in global demand, there is a negative effect due to the degree of penetration of imports to satisfy that demand. The greater the proportion of demand covered by imports, the smaller will be local production and employment. Third, the need to increase competitiveness quickly in a context of greater openness, on the one hand, and the change in relative prices in favour of imported inputs and machinery, on the other, lead to a significant reduction in the amount of labour per unit of production of the firms affected. This increase in labour productivity is the result of changes in the structure of production (for example, a smaller range of products, with a larger content of imported inputs), gains in efficiency through reorganization, and the replacement of labour with machinery.

As already noted, these processes have generally resulted in a tendency towards the contraction of industrial employment. In other words, the growth in the demand for industrial goods has not been sufficient to offset the negative components, namely, the direct displacement of local products by imports and the process of the reduction of the amount of local labour per unit of production which occurs in the surviving firms. It should be noted that it is the medium-sized and small firms which have the greatest difficulty in keeping going, so that the closure of this type of firm is a significant aspect of the overall contraction in employment.

It is worth emphasizing the role played by exchange-rate appreciation in each of the components thus disaggregated above. Let us consider the growth rate of the demand for industrial goods. The appreciated exchange rate acts as a restrictive factor because it hinders the growth of exports and also limits the growth rate of domestic demand. In the economy's long-term growth path, the external fragility associated with exchange-rate appreciation is a factor that limits the potential growth rate.

Exchange-rate appreciation also played a clearly negative role through the second of the above-mentioned components. Such appreciation joined with trade openness to further reduce the competitiveness of local activities. As a result –given the level of global demand– this tends to increase the effects of the direct displacement of local production and employment by imports. At the same time, it inhibits industrial production activities for the domestic market or for export which, with a more depreciated exchange rate, could have been competitive even in an open economy.

Lastly, exchange-rate appreciation also has a significant adverse effect on employment through the third channel: the microeconomic process of the reduction in the amount of labour per unit of production. The appreciated exchange rate exaggerates the incentives to reduce the amount of labour per unit of production in enterprises, because it also reduces the relative price of imported inputs and machinery compared with the cost of labour.

The macroeconomic configuration that tends to be formed in a process of trade openness with exchange-rate appreciation may be summarized in three main features. These are fragility of growth, high rates of unemployment, and a tendency towards growing inequality of income distribution. The external fragility implies difficulty in maintaining high growth rates without running the risk of external crises, and it forces the economy to follow a low growth path, which naturally inhibits the capacity to create employment. Secondly, behind this external fragility is the low international competitiveness of local activities. In Argentina, aggregate competitiveness did not tend to increase in the 1990s in spite of substantial improvements in labour productivity, because the change in relative prices neutralized the effects of that greater productivity.[7] The

[7] For calculations for various countries, made with a common methodology, see Tokman and Martínez (1999).

third feature is mainly a consequence of the first two. High unemployment, both by its very nature and by the downward pressure it exerts on wages, causes a persistent trend towards greater inequality of income distribution.

2. Employment, underemployment and unemployment in Argentina in the 1990s

In this section, we will present empirical evidence on the evolution of labour market conditions in Argentina in the circumstances described. We will begin by examining the evolution of aggregate employment, underemployment and unemployment in the decade in question.

The series analysed below refer to the urban population and are taken from the Permanent Household Survey (PHS) which the National Institute of Statistics and Censuses (INDEC) carried out twice-yearly, in May and October.[8]

Unless otherwise indicated, the series analysed here are defined as percentages of the total urban population. They are:

PART = participation rate;
EMPL = employment rate;
FTEMPL = full-time employment rate;[9]
SUB = involuntary underemployment;
U = unemployment rate.

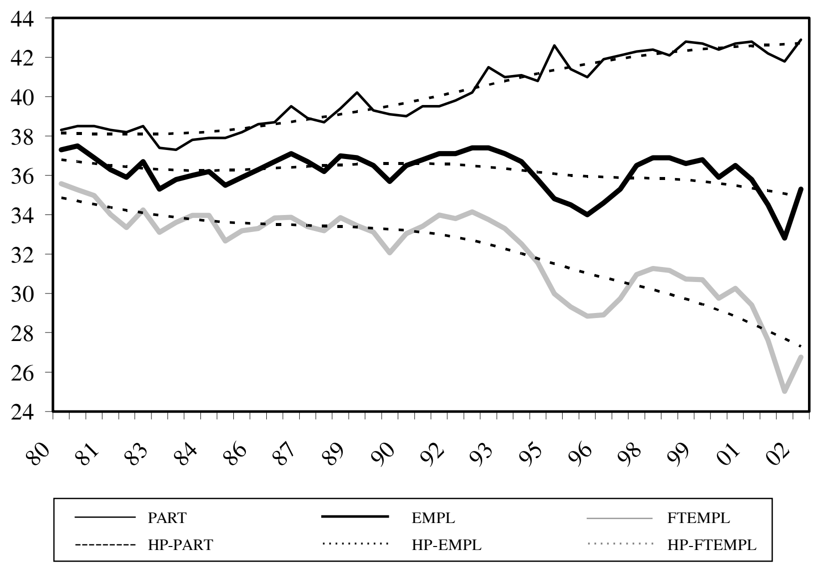
Figure 4 shows the evolution of these variables since the early 1980s. Firstly, it may be observed that the full-time employment rate shows a marked downward trend, dropping from 35-36% in the early years of that decade to 32% in the first half of 1990 and 27.6% in the second half of 2001.[10]

In addition to this negative trend, FTEMPL also displays clear correlation with the macroeconomic cycle. As in the case of the gross domestic product (GDP),

FIGURE 4

Argentina: Labour market indicators[a]

(As percentages of the total urban population)



Source: INDEC Permanent Household Survey.

[a] Participation rate (PART), employment rate (EMPL), full-time employment rate (FTEMPL), and their respective Hodrick-Prescott trends (HP-PART, etc.).

[8] The methodology and frequency of the PHS have recently been changed, as will be described below.

[9] In the survey, an individual is considered to be employed full time if he works at least 35 hours per week. This group also includes those who, although they worked less than 35 hours per week, do not wish to work more hours (i.e., this variable includes "voluntary underemployment").

[10] As in figure 4, in this section we have used half-year periods. Thus, the first half of the year corresponds to the survey carried out in May, while the second half corresponds to that carried out in October, so that 2000:1, for example, stands for the first half of 2000. Furthermore, in most cases in this section the % sign stands for "percentage points of the population". Henceforth, however, whenever there may be any ambiguity, we will use the expression "percentage points of the population" in full when referring to measurements of this nature.

this variable displays two clear cycles in the 1990s. It goes up as from 1990, then registers a pronounced fall reaching its lowest point in 1996, goes on to rise once again with the second period of expansion in the decade, but subsequently goes down again as from 1998.

It is important to note, however, that the highest level reached by FTEMPL in the period of expansion in the early 1990s was registered in the second half of 1992: i.e., before the turning-point in GDP observed at the end of 1994, after the Mexican crisis. Thus, in 1993 and 1994, when the economy was still expanding at a significant rate, the ratio between full-time jobs and the total population was already going down.

Between the high point of 34.14% and the minimum observed in the second half of 1996, FTEMPL fell by approximately 5.2%. It then recovered by about 2.4%, reaching a new peak in the first quarter of 1998. It should be noted, however, that the latter value is well below the maximum attained in the previous period of expansion.

The subsequent decline went along with the recessionary trend, both in the period of moderate contraction, up to mid-2001, and in the sharp fall in activity that occurred in the second half of 2001. At that moment, towards the end of the convertibility regime, FTEMPL was 6% below the level it had reached in the first half of 1991.

The ratio between total employment and the population (EMPL) also showed a downward trend in the early 1990s, but this was considerably less pronounced than in the case of FTEMPL, indicating that the rate of underemployment (involuntary underemployment), SUB, tended to rise in that same period. The increase in SUB became more marked in 1999-2000.

Furthermore, as we shall see below, SUB was counter-cyclical: it tended to rise when FTEMPL fell and to fall when the latter rose. Consequently, EMPL is less closely linked with the economic cycle than FTEMPL.

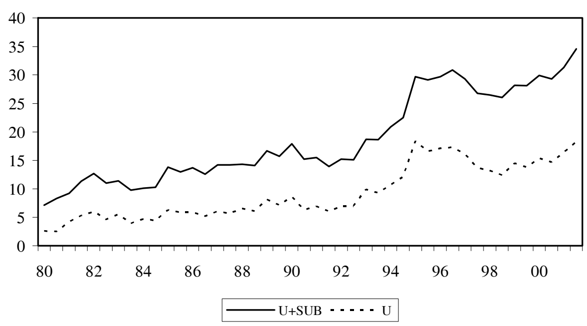
Finally, the rate of participation of the population in the labour force (PART) shows a markedly positive trend which is not correlated with the macroeconomic cycle. Starting from around 38% in 1980, it went up to 39% in 1990 and then rose sharply still further, reaching 42.8% in the first half of 2001. Throughout the convertibility period, the trend of PART corresponded to an increase of approximately one percentage point of the urban population every three years. The main reason for this behaviour was the sustained increase in female participation in the labour force, although this participation is still low in Argentina by international standards.

As a result of the positive trend of PART and the relative stagnation of the employment rate, the unemployment rate (U) rose sharply in the 1990s, with a marked upward jump in the 1992-1995 period (figure 5).

The impact of the 2001-2002 crisis caused a further unfavourable jump in these indicators. The urban open unemployment rate rose to a peak of 21.5% in May 2002 but began to go down thereafter. Under-employment, for its part, reached a peak of 19.9% of the economically active population in October 2002 but also went down afterwards when the economic recovery began to take hold.

FIGURE 5

Argentina: Rates of unemployment (U) and involuntary underemployment (SUB)



(As percentages of the urban active population)

3. The evolution of employment and unemployment in the recent recovery phase

a) *Full-time employment*

In 2002, with economic reactivation, employment began to recover. In this section[11] we will first of all analyse the evolution of full-time employment since the second half of 2002. We are interested in obtaining a long-term view which will allow us to analyse changes over time and make comparisons with the period when the convertibility regime was in force. A difficulty in this respect, however, is that the twice-yearly permanent household survey (PHS) was discontinued in the first half of 2003 and replaced with an ongoing PHS which gives quarterly figures. The results of the ongoing PHS, by quarters, are available as from the first quarter of

[11] Both the analysis of the recent evolution of employment and unemployment, in the present section, and that of wages (further below) are based on Damill and Frenkel (2003) and Frenkel (2005).

2003, but the employment rates of the two surveys are not directly comparable because of changes in the methodology used.

In order to solve this problem, we proceeded as follows. We calculated half-yearly averages of the employment rates of the ongoing PHS, so as to have half-yearly data with a frequency similar to that of the PHS in the past. Moreover, instead of working with the levels of the employment rate, we calculated a long series of half-yearly differences (i.e., the difference between one half-year and the preceding one). The coupling together of the series of differences between half-year periods from the half-yearly surveys and the data from the ongoing surveys was effected by taking advantage of the fact that in the case of the first half of 2003 we have observations made in both surveys. This makes it possible to calculate all the differences with half-yearly data from a single PHS: the twice-yearly one up to the first half of 2003 and the ongoing one as from the second half of that year. Although the half-yearly differences thus calculated are not strictly homogeneous, the error arising from this procedure may be assumed to be very slight.

Let us call the variable that interests us D(FTEMPL). This is the difference in the full-time employment rate, **without social plans**, between one half-year and the preceding one. The exclusion of social plans when measuring FTEMPL is important, because the introduction of the Plan for Heads of Households led to a considerable increase in the voluntary underemployment rate.[12] If the full-time employment rate did not exclude the social plans, it would register an increase which had nothing to do with the economic processes. The full-time employment rate considered by us therefore **excludes** those working under social plans. The variable D(FTEMPL) is measured in percentage points of the total urban population. The tables below show the evolution of this variable from the second half of 2002 up to the first half of 2004, together with the de-seasonalized half-yearly growth rates of GDP which we have called DL(GDP).

Table 3 shows that in the four half-years considered, the GDP registered a cumulative increase of 15.9%, while the full-time employment rate went up by 4.56% percentage points of the urban population.

TABLE 3

Argentina: Variation in full-time employment rate between one half-year and the similar preceding period, without social plans

Half-year	D(FTEMPL)	DL(GDP)*100
2002:2	0.68	1.32
2003:1	1.06	5.07
2003:2	1.86	5.32
2004:1	0.96	3.37

Source: Prepared by the authors.

b) *Full-time employment and the recent behaviour of unemployment*

In 2003 and the first half of 2004, the increases in full-time employment (without social plans) accounted for the whole of the reductions observed in unemployment rates. This may be seen in table 4, which shows the half-yearly variations in unemployment and full-time employment. In order to facilitate comparison, the variations in unemployment D(U) are expressed as percentages of the total urban population.

TABLE 4

Argentina: Half-yearly variations in unemployment and full-time employment

Half-year	D(U)	D(FTEMPL)
2003:1	-0.94	1.06
2003:2	-1.08	1.86
2004:1	-0.35	0.96

Source: Prepared by the authors.

In all the half-year periods, the increases in the full-time employment rate without social plans exceeded the corresponding falls in unemployment in absolute values.

In short, since 2003 the contractions observed in unemployment are explained by the increases in the full-time employment rate without social plans; these plans were present, as a relatively stable background to the situation, throughout the period in question. Consequently, the changes in labour market conditions as from that year can be represented by the variations in unemployment rates and also in the full-time employment rates.

4. An aggregate model for the labour market[13]

These stylized facts regarding the indicators of labour use can be organized in a simple labour market model,

[12] We refer to the Plan for Heads of Households set up in 2002 to relieve the serious social situation generated by the worsening of the crisis. Under this Plan, allowances of 150 pesos are given to heads of households with children, in return for a certain amount of work.

[13] For more detailed versions of this model, as well as econometric estimates of it, see Frenkel and González Rozada (2000a and 2000b) and Damill, Frenkel and Maurizio (2002).

with an employment level determined by demand and relative prices, an underemployment function which reflects the counter-cyclical behaviour of this variable, and an exogenous participation rate (which follows a positive trend, as already mentioned). Thus, the unemployment rate is obtained as the difference between the exogenous participation rate and the employment rate determined by demand.

The behaviour of employment is associated with the economic activity trend. The evolution of total employment (as defined by the Permanent Household Surveys), however, although related with GDP, does not display a close correlation with that variable indicative of the level of activity. The main reason for this weak correlation is the dynamic behaviour of one of the components of the employment aggregate: involuntary underemployment, which displays counter-cyclical dynamic behaviour, like unemployment. In contrast, full-time employment is markedly pro-cyclical in the short term. In short, involuntary underemployment evolves in the short term in a direction which is opposite to that of full-time employment, so that the total employment aggregate varies more tenuously and "noisily" than full-time employment.

The level of activity is not the only determinant of the aggregate demand for labour. Other factors, such as relative prices, also affect the growth or contraction of employment. As in the case of the level of activity, the incidence of other macroeconomic factors which are determinants of labour demand can be seen more clearly through their effects on full-time employment. This is the aggregate variable of the labour market which best describes the linkages of that market with macroeconomic processes. Consequently, in order to analyse these linkages it is best to proceed in two steps: first, to examine the factors determining full-time employment, and second, to model the behaviour of total employment as a function of full-time employment and other variables.

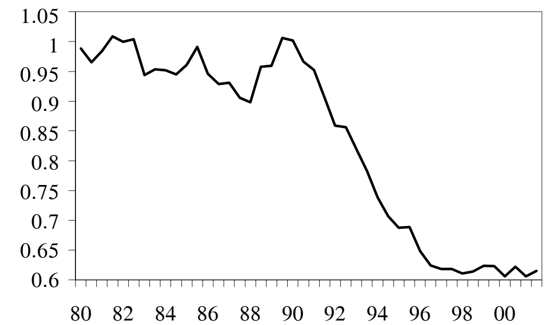
The summary description of the main employment variables in Argentina which we gave in the previous section shows that the demand for labour, represented mainly by the variable FTEMPL, underwent profound changes in the 1990s. Although the ratio between full-time employment and the population had been going down since the 1980s, it was in the 1990s that this trend became perceptibly more acute.

Thus, various factors contributed in that decade to clear changes in firms in terms of production technology and production organization. Among these factors, trade openness and exchange-rate appreciation were undoubtedly among the most important.

FIGURE 6

Argentina: Ratio of full-time employment rate to GDP, 1980-2000

(1990:1 = 1)



Source: Prepared by the authors on the basis of data from INDEC and the Ministry of the Economy and Production.

The changes which took place in the demand for domestically produced goods and in relative prices affected firms' labour use. Figure 6 shows the ratio between the full-time employment rate and GDP. Starting from a tendency towards stagnation in the 1980s, the curve shows a striking fall between 1991 and 1996, after which the trend is once again one of stagnation.

As already noted, the new macroeconomic scheme did not emerge gradually. The main institutional changes and the change in relative prices mostly took place in the early 1990s. In view of this, we suggest that the adjustment in labour demand may be conceived as a process of admittedly gradual adaptation to a new environment defined from the beginning.

In order to examine the relation between activity growth and variations in the full-time employment rate, we worked out the following model:

$$D(FTEMPL) = a\ DL(GDP) + b\ DUMINIC + d\ DUMRECU + c + \varepsilon$$

where *D(FTEMPL)* and *DL(GDP)* have the meanings already mentioned. *a, b, c* and *d* are estimated parameters, and ε is a random variable. The model states that the half-yearly variations in the full-time employment rate are due to a short-term effect of the level of activity and an additional tendency, which may be conceived as the slow adjustment of the full-time employment rate to the surrounding conditions (mainly defined, at the beginning of the 1990s, by exchange-rate appreciation and trade openness).

The above model was estimated on the basis of half-year series providing data for the period from the first half of 1991 to the first half of 2004 (table 5).

The results of the estimation by ordinary least squares (OLS) are shown in table 5.

TABLE 5

Argentina: Estimation of model on behaviour of full-time employment by the ordinary least squares method

Dependent variable: D(T)
Sample (adjusted): 1991:1 2004:1
Number of observations: 27 after adjustment of end points
Standard errors and covariance consistent with White's heteroscedasticity

Variable	Coefficient	Standard error	t-statistic	Probability
DL(GDP)*100	0.19	0.03	6.36	0.000
DUMINIC	-0.64	0.27	-2.35	0.028
DUMRECU	0.62	0.26	2.35	0.028
C	-0.21	0.18	-1.14	0.260
R^2	0.72	f-statistic		19.27
Adjusted R^2	0.68	Probability (f-statistic)		0.000
Durbin-Watson statistic	2.54			

Source: Prepared by the authors on the basis of data from the Permanent Household Survey of the National Institute of Statistics and Censuses (INDEC) and the Ministry of the Economy and Production.

DUMINIC is a dummy variable, with a value of 1 between the first half of 1991 and the first half of 1996 and a value of 0 for the rest of the period, which was brought in to capture the magnitude and direction of the trend towards the contraction of full-time employment in the first five years of the convertibility regime.[14] DUMRECU is a dummy variable, with a value of 1 between the second half of 2002 and the first half of 2004 and a value of 0 for the rest of the period, which captures the additional trend in the recent recovery period.

The coefficients are significant at the 3% level, and the constant is not significant. The coefficient of variation of GDP is 0.19: an increase of 10% in GDP gives 1.9 percentage points of increase in the full-time employment rate. In addition to the short-term effect of the variation in activity level, the coefficients of DUMINIC (-0.64) and DUMRECU (0.62) describe tendencies (of the full-time employment rate) additional to those established by the rate of variation of GDP.

This additional trend is negative in the first phase of convertibility. It is the autonomous tendency towards a decline in full-time employment which may be interpreted as the result of slow adaptation to the relative prices context of the 1990s. In contrast, this additional trend is positive in the recent period of recovery.[15] In this last-named period, it corresponds to autonomous annual growth of the full-time employment rate by rather more than 1.20 percentage points of the total urban population.

[14] See Damill, Frenkel and Maurizio (2002).

[15] In Damill, Frenkel and Maurizio (2002) we give econometric estimates of this model for the period from 1980 to the first half of 2001, some of which are briefly summarized in this note.

The equations estimated there for the 1990s have the following form: $d\ log\ FTEMPL = \alpha\ dlog\ YR + \lambda\ Dpost96 + \beta$, where the dependent variable is not the rate of change of the number of full-time jobs but the rate of change of FTEMPL, which in turn is equal to the rate of change of the number of persons with full-time jobs (*dlog N*) less the population growth rate (*dlog POB*), which is expressed as follows: $dlog\ FTEMPL = dlog\ N - dlog\ POB$.

The estimated coefficient β therefore reflects the joint negative effect on FTEMPL of the adjustment of employment to the new context, on the one hand, and population growth, on the other.

The variable *Dpost96* is a dummy variable designed to capture a change in labour demand after 1996. This variable has a value of zero up to the second half of 1996 and a value of 1 for all the subsequent half-year periods.

The econometric estimates of these equations give the following results for the 1990s. First, the elasticity a is positive and significantly different from zero. The estimates gave a value of approximately 0.6. This elasticity means that the full-time employment rate tended to grow (or fall) by 1 percentage point for every 6% of GDP growth (or contraction). The GDP-elasticity of full-time employment in the 1990s was greater than that for the 1980s.

The estimated parameter β was also significantly different from zero and was negative. The quantitative estimates indicated a tendency of the full-time employment rate to contract by 1.44 percentage points per year in the 1991-1996 period, which may be interpreted as the autonomous downward tendency of full-time employment –for a constant level of GDP– resulting from the gradual adaptation to the relative prices context of the 1990s.

Another important result is that for *Dpost96*. The estimated coefficient of this dummy variable was positive, with an absolute value very similar to that of the β estimator. This means that the autonomous tendency towards contraction β became zero in the period after 1996.

In the recent recovery period, the half-yearly increase in the full-time employment rate is explained very well by the equation:

$$D(FTEMPL) = 0.19 * DL(GDP)*100 + 0.62$$

(bearing in mind that DUMINIC = 0 in this period). Thus, for example, if the product grows by 8% in a year, the variation in the full-time employment rate can be estimated as approximately 0.19*8 + 1.24 = 2.76 percentage points.

Assuming that the function is stable, it is possible to project the contribution of GDP growth (through the full-time employment rate without social plans) to the decline in the unemployment rate. An increase of 10% in GDP in a given year would cause the full-time employment rate to rise by 0.19*10 + 1.24 = 3.14 percentage points of the total urban population. For an activity rate of 46%, this increase in the full-time employment rate would be equivalent to nearly 7 percentage points of the active population.

In order to complete the description of the aggregate labour utilization indicators, we must also take into account the evolution of involuntary underemployment. As already noted, this variable displays a counter-cyclical type of behaviour, so that it is negatively correlated with full-time employment. Our estimates using data from the 1990s indicate that the involuntary underemployment rate tends to fall (or rise) by 0.2 percentage points for each percentage point of increase (or decline) in the full-time employment rate. Thus, the increase (fall) in total employment resulting from an increase (fall) in full-time employment is less than the latter, since the variations in total employment are the result of adding together the variations in full-time employment and involuntary underemployment.

5. The contraction of employment in the 1990s, by sectors of production

a) *Full-time employment, by sectors of production*

So far, we have been examining the aggregate employment indicators generated from the nationwide Permanent Household Survey. The main urban area of the country, which comprises the city of Buenos Aires and the surrounding administrative areas, is Greater Buenos Aires (GBA), which accounts for around 37% of the total urban population. In the present section 5 we will be basing our examination on this subset of the sample –i.e., GBA– in order to analyse the evolution of employment at a more disaggregated level.

It has been argued above that in the 1990s there was a clear tendency towards the contraction of the ratio between full-time jobs and the population. Table 6 shows this ratio for GBA, by sectors of activity.[16] The figures include both the beginning and the end of the period of operation of the convertibility regime, as well as the maximum and minimum levels registered in it, and also the difference between the two extremes of the period (in the right-hand column).

As we already noted, trade openness and exchange-rate appreciation contributed to the contraction in employment in the 1990s through their negative impact on the sectors producing tradeable goods. Thus, table 6

TABLE 6

Argentina: Full-time employment rate, by sectors of production

(As a percentage of the total population of GBA; selected half-year periods)

	1990:1	1992:2	1996:2	1998:1	2000:2	2001:1	2001:2	Difference 2001:2-2001:1	Difference 2001:2-1990:1
Manufacturing	8.54	8.76	6.33	6.69	5.55	5.20	4.66	–0.54	–3.88
Construction	1.91	2.30	1.81	2.17	1.89	1.60	1.22	–0.37	–0.69
Commerce	6.60	7.17	6.22	6.15	6.55	6.00	5.79	–0.20	–0.81
Transp. and comm.	2.75	2.43	2.93	3.00	3.05	3.01	2.72	–0.29	–0.03
Financial services	2.38	2.59	3.33	3.66	3.74	3.26	2.93	–0.33	0.55
Other services	7.95	7.70	6.56	7.62	7.49	7.32	6.94	–0.38	–1.01
Total	*30.13*	*30.95*	*27.18*	*29.29*	*28.27*	*26.38*	*24.27*	*–2.11*	*–5.86*

Source: Prepared by the authors on the basis of data from INDEC.

[16] The definition of full-time employment used in this section is more restrictive than that used earlier in this study, since it excludes the voluntary underemployed. On the other hand, it may be noted that the figures for Greater Buenos Aires are very close to the nationwide figures. Thus, for example, the variation in FTEMPL was –1.86 percentage points between the first half of 1990 and the second half of 2000 in the case of Greater Buenos Aires (as may be seen from the table) and –1.8 percentage points at the nationwide level.

confirms that the considerable decline in the full-time employment rate in manufacturing explains most of the aggregate behaviour. The other two sectors with a substantial share in the number of full-time jobs (commerce and other services) also show negative figures, but much smaller. More exactly, in the period up to the first half of 2001, the contraction of this class of employment in industrial activities accounted of itself for a reduction in the number of full-time jobs equivalent to the total contraction in full-time employment. The collapse in activity in the second half of 2001, however, caused a contraction which was more uniformly distributed among the various sectors, thus tending to reduce to some extent the share of manufacturing in the total contraction in employment between the beginning and end of the period.

Furthermore, if we examine the evolution of full-time employment by categories, we see that the job losses were particularly marked among male workers and heads of household, who traditionally predominate in the manufacturing sector.[17]

The decisive weight of manufactures in the evolution of FTEMPL warrants an examination of employment in this sector in greater detail, and this is done in the following section.

b) *Industrial sector employment*

The Survey of Industrial Establishments which is published monthly by INDEC provides additional information on manufacturing. It is of nationwide scope and covers some 1,300 firms with over ten workers.

Figure 7 shows the series for physical volume of production, hours worked, and number of persons employed throughout the 1990s, on the basis of that survey.

The evolution of industrial employment can be explained through a model similar to that describing the behaviour of total full-time employment which was given above.[18] In this case we specifically estimate the effect of the new conditions of openness and exchange-rate appreciation on employment in manufacturing, on the basis of an industrial employment demand function with the following form:

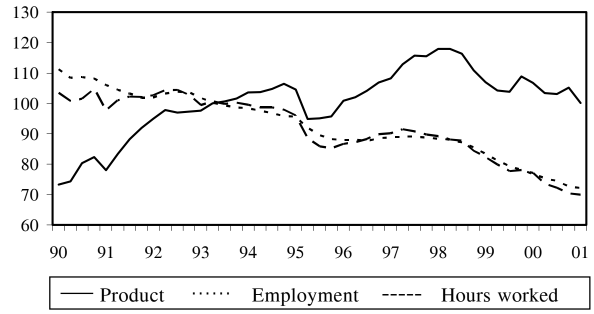
$$d \log Nind = \alpha\, d \log (GDP) + s$$

where *Nind* (employment in industry) is defined as the number of workers employed (*Npers*) or the total number

FIGURE 7

Argentina: Manufacturing employment and product

(1993 = 100)



Source: INDEC.

of hours worked (*Nhours*); GDP represents the physical volume of production, while a is the employment-production elasticity and *s* represents the gradual adjustment of manufacturing employment to the conditions prevailing since the beginning of the 1990s.

The econometric estimates of equations with the above form, made with quarterly data for the period from 1990:0 to 2001:1, gave the results shown below.

First, the estimates of *s* were significant and were approximately –1% (quarterly), which implies an autonomous tendency to the contraction of industrial employment by rather more than 4% per year. This contractive tendency has a larger absolute value than that estimated for total full-time employment in the same period. This is in keeping with the hypothesis predicting a stronger contraction in the tradeable goods sector.

Second, unlike what was observed in the case of total full-time employment, the contractive tendency does not disappear in the second half of the 1990s, but persists up to the end of the period.

Third, the estimates for employment-production elasticity were significant and positive. As in the case of total full-time employment, manufacturing employment varies in the short term in line with the level of activity. With employment measured terms of the number of workers employed, the elasticity estimates are between 0.14 and 0.16. When measured in terms of the number of hours worked, the elasticities are between 0.55 and 0.59.

The considerable difference between the elasticities based on persons employed and those based on hours worked indicates that labour hoarding took place.

[17] See Damill, Frenkel and Maurizio (2002 and 2003).
[18] See Damill, Frenkel and Maurizio (2002 and 2003).

6. Evolution of average income in the 1990s

The rates of employment generation and unemployment, already analysed in this section III, are decisive variables for understanding the evolution of the incomes obtained by the population as a whole. In this sub-section we will deal initially with the evolution of the average income of the population in the 1990s and then go on to deal with the distribution of that income.[19]

Figure 8 shows the evolution of real average income per employed worker and per member of the active population from the first half of 1991 until October 2002. Both series follow pro-cyclical paths. In the period of expansion at the beginning of the decade, the average income of workers grew by 22% (reaching a peak in the first half of 1994), while that of the active population grew by 19%. From then on, both series showed downward trends, reaching local minimum levels in the second half of 1996. A second cycle then began, whose expansionary phase extended up to the second half of 1998, although neither of the series recovered their previous peak levels. Subsequently, the incomes of both workers and of the active population as a whole went down persistently until the end of the period shown by the figure.

In October 2001, before the end of convertibility, the income level of employed persons was 7% higher than at the beginning of the series, while in the case of the active population it was 6% lower, with both levels clearly below the peak registered in the first half of 1994. This shows that only at the beginning of the 1990s was there a substantial increase in real income, due basically to the price stability and economic growth registered in those years. Between the end points of the series, income went down by 30% in the case of employed persons and 38% in that of active persons as a whole.

The growing gap between the two series shown in figure 8 reflects the impact of the rise in the unemployment rate in Greater Buenos Aires from 1993 on, and especially from the second half of 1995 on. At that point, the average income of the active population suffered a sharp contraction. The reduction in unemployment between the end of 1996 and 1998 helped to reduce the gap somewhat, but this trend was reversed in the phase when there was a sustained increase in the unemployment indices. While at the beginning of the 1990s the average income of active persons was equivalent to 93% of that obtained by workers as whole, towards the end of the period studied that proportion had gone down to 82%.

FIGURE 8

Argentina: Average real income of employed workers and active individuals, 1991-2002
(In constant May 1998 pesos)

Source: Prepared by the authors on the basis of data from INDEC.

These facts are extremely important when trying to explain the trend in household incomes. Figure 9 shows the dynamics of per capita family income.

Figure 9 shows phases of growth and decline similar to those referred to earlier. Per capita income grew by 23% up to the first half of 1994, but then fell sharply up to the first half of 1996. The subsequent partial recovery stopped in 1998. After that, following the tendency of labour income, the series went down sharply up to the end of the period. After the increase in the early years, by the end of the currency board regime average income had gone back to its initial level, and the resurgence in inflation early in 2002 caused a further loss of around 30% in average income.

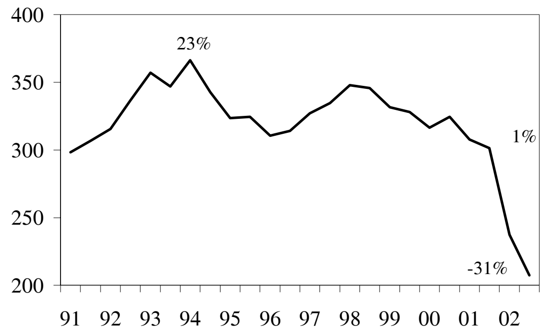
It may be concluded, then, that the unfavourable macroeconomic environment and the correlated sluggishness of the labour market –with low levels of demand for labour, predominance of precarious forms of employment and rising levels of unemployment– was reflected in a sharp drop in wages from 1994 on, later aggravated by the price rises which followed the abandonment of the system established in 1991.

Special mention should be made of the effect of the rising levels of unemployment on the generation of household income. The severe fall in the average income of the active population between the two end points of the period studied was due both to the behaviour of the wages of employed persons and the

[19] The income figures given in this sub-section, as well as the tables on its distribution given below in sub-section 7, correspond to data from the Permanent Household Survey for Greater Buenos Aires.

FIGURE 9

Argentina: Average real per capita family income
(In constant May 1998 pesos)



Source: Prepared by the authors on the basis of data from INDEC.

evolution of the unemployment level.[20] The latter factor has a direct impact on the generation of income from economic activities, since people who are unemployed probably do not have any income at all. The high levels of unemployment throughout the decade also had a substantial indirect negative effect on the wages of the employed population, as reflected in a high negative elasticity of remunerations to unemployment, as we shall see in the following sub-section.

7. Remunerations and unemployment

In this sub-section we will analyse the income of employed workers in the light of the evolution of unemployment. Unemployment has a direct and obvious impact on the average income of the active population, but it also affects the remunerations of employed persons. There are various theoretical schemes, such as the insider-outsider model for the determination of wages, the argument based on "efficiency wages" and the determination of wages through negotiation between trade unions and employers, which can explain the existence of a negative elasticity of real wages to unemployment. This relation can be termed the "wage curve", and we will estimate this relation for the Argentine labour market in the 1990s below.

a) *The wage curve in the 1990s*

We estimated wage equations using micro-data taken from the Permanent Household Survey (PHS) in the period from the first half of 1990 to the second half of 1998, on the basis of individual data for 11 urban centres studied by the PHS.

The estimated wage equation is as follows:

$$\ln w = \partial\,(x, U_r, r, s, \text{DUMINIC})$$

where w represents workers' wages in real terms and U_r stands for the unemployment rates in the different urban centres, in logarithms. The terms x, r and s correspond to control variables: x is a vector of workers' characteristics (sex, education, type of occupation and age, and age squared as proxies for the returns to experience), and r and s are vectors of dummy variables (regional and sectoral, respectively). The control group consists of full-time wage-earners in the manufacturing sector who are males, live in Greater Buenos Aires and have full primary education. Finally, DUMINIC is a dummy variable whose value is 1 between the first half of 1990 and the second half of 1993 and 0 thereafter. This variable captures the initial effect of the convertibility plan on the real income of workers.

Since unemployment rates varied from one region to another and over time, the coefficient estimated for that rate may be interpreted as the unemployment-elasticity of remunerations over time and by region.

Unemployment can affect total income in two ways. On the one hand, it reduces the number of hours worked, and on the other in can negatively affect hourly wages.

We thus estimated the unemployment-elasticity of the latter, and also of total income. In addition, we estimated an equation in which the hours worked (in logarithms) depend on the same explanatory variables, in order to distinguish the effect of the hourly wages (price effect) of the number of hours worked (quantity effect) on total income. We made separate estimates for full-time wage-earners and for all employed persons as a whole. We found that although the unemployment rate adversely affects hourly wages in all cases, it only affects the number of hours worked in the case of involuntarily underemployed workers. This effect was observed as from the first half of 1993.

Table 7 shows the estimates of the unemployment-elasticity of hourly wages. The estimates corresponding to hours worked and total income will be given further below, but only for the group of involuntary underemployed.[21]

[20] For an analysis of the way income distribution evolved from the beginning of the 1990s on, see Damill, Frenkel and Maurizio (2002 and 2003). See also Frenkel and González Rozada (2000b), Altimir and Beccaria (2000) and Beccaria and Maurizio (2001).

[21] The unemployment-elasticities of real wages obtained by us are very similar to those estimated for the United States, for example. For more details, see Blanchflower and Oswald (1996).

TABLE 7

Argentina: Unemployment-elasticity of real hourly wages

Variable	Hourly wages	
	Full-time All employed	wage- earners persons
Log(unemployment rate/100)	-0.095	-0.102
	(-17.74)	(-20.88)
DUMINIC*log(unemployment rate/100)	0.027	0.028
	(16.09)	(18.41)

Source: Prepared by the authors on the basis of data from the INDEC Permanent Household Survey.

TABLE 8

Argentina: Elasticity of real hourly wages to sum of unemployment and underemployment rates

Variable	Hourly wages	
	Full-time All employed	wage- earners persons
Log(unemployment + underemployment rate/100)	-0.133	-0.150
	(-20.86)	(-25.64)
DUMINIC*log(unemployment + underemployment rate/100)	0.039	0.043
	(17.86)	(21.17)

Source: Prepared by the authors on the basis of data from the INDEC Permanent Household Survey.

The explanatory variable in the wages equation was defined alternatively as the unemployment rate in the strict sense, or as the sum of this latter with the involuntary underemployment rate (table 8). In all the estimates, the ordinary least squares method was used. The coefficients estimated for the control variables were very significant in most cases and are very similar to those obtained for the statistical function of income estimated for the whole period. We left them out in the following tables.

In all the estimates the coefficients of the explanatory variables are very significant and have the expected sign (in the tables, the *t* statistics are shown in brackets under the estimator). These findings therefore do not reject the hypothesis of a negative unemployment-elasticity of income. At the same time, the coefficient of the DUMINIC variable is significant and positive, which indicates that the wage-unemployment elasticity was lower at the beginning of the period, when unemployment was not yet increasing.

The estimated elasticities are lower for full-time wage-earners than for the rest of the employed population: -0.095 for the former, as against –0.102 for employed workers as a whole.

This indicates that the group of non-wage-earners and involuntary underemployed displayed somewhat greater flexibility of their remuneration. Whereas an increase of 10% in the unemployment rate caused a fall of 0.95% in the hourly wages of full-time wage-earners, there was a fall of 1.02% in the case of the employed population as a whole.

It may be noted that the involuntary underemployment rate has a further negative effect on income. As may be seen from table 8, if this rate is added to unemployment, the estimated elasticities are –0.133 for full-time wage-earners and -0.150 for employed persons in general.

Let us now examine the estimated elasticities for the involuntary underemployed (table 9). The explanatory variables are the same, but the DUMINIC variable was suppressed because of the period considered in this case.

Table 9 shows that the increase in the unemployment rate adversely affects this group in two ways: through the reduction in hourly wages, on the one hand, and through a decline in the number of hours worked, on the other. An increase of 10% in the unemployment rate caused a contraction of 1.15% in hourly wages and a reduction of 1.35% in the number of hours worked. The total fall in income of the involuntary unemployed was therefore 2.5%.

Finally, we estimated the wage curve for full-time wage-earners separately for each of the urban centres in the sample, in order to determine whether the elasticities estimated primarily reflect the effect of variations in unemployment over time, or of variations between regions. The control variables used were the same and the coefficients estimated were significant in almost all cases. Table 10 shows the elasticities estimated for each urban centre.

It may be seen from table 10 that the unemployment-elasticities of real wages were negative and significant, except in Santa Cruz and Tucumán, which indicates that the coefficients estimated earlier basically reflect the effect of unemployment over time. The unemployment rates increased markedly during the 1990s in all the urban centres. When the equation is estimated for the whole sample, without including the dummy variables for each urban centre, the resulting elasticities are still significant, but less so than when the fixed effects are taken into consideration.

TABLE 9

Argentina: Unemployment-elasticity of real wages and of hours worked by underemployed persons

Variable	Hourly wages	Hours worked	Total remuneration
Log(unemployment rate/100)	-0.115	-0.135	-0.250
	(-6.58)	(-8.24)	(-13.65)

Source: Prepared by the authors on the basis of data from the INDEC Permanent Household Survey.

TABLE 10

Argentina: Estimates of elasticities, per region

Variable	Hourly wages	
	Log(unemployment rate/100)	DUMINIC*log (unemployment rate/100)
Whole sample	–0.073	0.026
	(–22.95)	(19.23)
Greater Buenos Aires	–0.120	0.036
	(–9.71)	(8.11)
Córdoba	–0.100	0.057
	(–7.75)	(11.65)
Jujuy	–0.092	0.021
	(–6.59)	(3.97)
La Pampa	–0.119	0.030
	(–10.64)	(7.71)
La Plata	–0.063	0.030
	(–3.81)	(5.53)
Mendoza	–0.301	0.046
	(–10.38)	(8.84)
Neuquén	–0.325	0.059
	(–5.86)	(4.76)
Rosario	–0.175	0.052
	(–5.34)	(7.09)
Salta	–0.169	0.016
	(–7.37)	(2.62)
Santa Cruz	0.017	0.016
	(0.85)	(4.81)
Tucumán	–0.034	0.035
	(–0.80)	(3.80)

Source: Prepared by the authors on the basis of data from the INDEC Permanent Household Survey.

b) *The wage curve in the recovery phase*

In the previous sub-section we analysed the relation between wages and the unemployment rate in the convertibility period. In this sub-section we will use a similar methodology to examine the recent recovery phase, on the basis of information from the Permanent Household Survey carried out in 2003 and the first half of 2004. As in the previous case, the estimates do not reject the association between variations in wages and unemployment. In this case, the increases in real wages are associated with the reduction in unemployment rates.

The relation between variations in wages and unemployment rates is analysed in both its temporal and geographical dimensions. The regional dispersion of wage increases and the concomitant differential evolution of unemployment rates in the period in question enhance the information available for testing the hypothesis.

The model estimated is similar to that of the previous sub-section. It assumes that workers' wages depend on individual characteristics (the region where they work, their level of education, the sector of activity in which they are employed, the size of their firm, their sex, and their age) and on the unemployment rate in the region to which they belonged at the time that the information was collected. The presence of regional dummy variables in the estimates takes account of the fixed effects of inter-regional differences in wage levels.

In addition to the estimates for the whole country, estimates were also made for each of the regions studied. In these estimates, the control variables are education, sector of activity, size of firm, sex and age.

We made separate estimates for officially registered and non-registered workers. We also made estimates for other categories of workers (such as own-account workers) in order to show that the evolution of their income was likewise associated with the indicators of changes in the labour market.

Table 11 shows the elasticities estimated for the nationwide level and for each of the regions studied, for the groups made up of registered and non-registered workers. The elasticities are significant at the 1% level, except where otherwise stated.

TABLE 11

Argentina: Unemployment-elasticities of registered and non-registered workers

Region	Elasticities (registered workers)	Elasticities (non-registered workers)
Greater Buenos Aires	–0.34	–0.46
Cuyo	–0.45	–0.49
North East Argentina	–0.48	–0.34
North West Argentina	–0.56	0.00[a]
Pampa	–0.40	0.00[a]
Patagonia	–0.29	–0.33
Total	*–0.34*	*–0.461*

Source: Prepared by the authors on the basis of data from the INDEC Permanent Household Survey.

[a] Not significant.

All the regional elasticities estimated are highly significant in the case of registered workers. For these workers as a whole, the elasticity estimated is –0.34, which is highly significant. This elasticity means that a fall of 10% in the unemployment rate (for example, a contraction of 1.5 percentage points of the active population, if the unemployment rate is 15%) represents an increase in wages of 3.4%.

In the case of non-registered workers, the elasticities are significant at the nationwide level and by regions, except in the North West Argentina and Pampa regions. This is in keeping with the fact that in these latter two regions the estimated variations in the wages of non-registered workers are very small.

(*Original: Spanish*)

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Social precarity in Mexico and Argentina:

Trends, manifestations and national trajectories

María Cristina Bayón

From a multidimensional and dynamic approach, this article focuses on the linkages between labour, unemployment, poverty and inequality, examining the forms which social precarity has adopted in Mexico and Argentina in the new economic environment. It contends that the weakening of employment-based integration mechanisms, marked inequalities in access to opportunities and increasingly rigid social structures are evidence of strong exclusionary trends, which exhibit specific characteristics in each country. After analysing national trajectories and the levels of integration achieved under the import-substitution industrialization model, the article examines the deterioration of working and living conditions witnessed over the last few decades. It concludes with a discussion of some of the dilemmas and challenges which the transition towards more equitable, socially supportive and inclusive societies poses in terms of research and public policy.

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I

Introduction

The labour market has not only lost its capacity to promote integration and social mobility, but has also become one of the main sources of vulnerability and social exclusion for large, growing sectors of the population. Increased levels of unemployment, labour insecurity and social vulnerability not only suggest a progressive weakening of the relationship between economic growth and employment, but also cast serious doubts on the ability of the new economic model to absorb the labour supply and reduce poverty and persistent, growing inequalities.

The drive towards integration, as Pérez Sainz (2003) has pointed out, does not feed into the globalization process, and the labour market plays a larger role in the dynamics of social dis-integration today than it did in the past. In addition to the erosion of earlier integration mechanisms, rising disparities in the distribution of opportunities to access the "advantages" of current processes reflect a social structure that is becoming increasingly rigid. The initial conditions of an individual's life play an ever more important role in determining his or her fate, and inherited disadvantages exact a heavy toll in an environment marked by hostility towards the "losers" in the new social game.

Social, economic and political institutions act as mediators in the relationship between inequality in the distribution of income and social exclusion, either favouring or blocking opportunities for the shared social experience that is essential to the exercise of citizenship.[1] In Latin America, social exclusion processes are reflected in the conditions that accompany the incorporation of vast sectors into society, in their integration patterns (Faria, 1995), which lead to an unfavourable form of inclusion (Sen, 2000) and the creation of a second-class type of citizenship (Roberts, 2004). Disadvantages in this case do not arise from being "left out", but rather from the segmentation produced by State institutions –in other words, from differentiated inclusion in the social system. This segmentation is a historical feature of Latin American "welfare regimes", and has emerged with renewed force as social services are progressively dismantled and "commodified", drastically widening social gaps through differential access to employment, education, health care and housing opportunities, and through differences in the quality of such opportunities.

The patterns and trajectories of these inclusion processes display different characteristics in different social contexts. The diverse nature of the social structures of Latin American countries and the different forms which expectations of well-being and equity can assume –depending on the urbanization and social stratification patterns, labour traditions and welfare mechanisms involved in each case– must be acknowledged in order to avoid simplistic, overly broad assessments of the forms which social precarity adopts in the new economic environment.[2] The cumulative disadvantages (Paugam, 1995) associated with work precarity and precarity in other areas of economic and social life (family, income, living conditions and social contacts) is precisely what makes certain groups more vulnerable than others to social exclusion.

The experiences of Argentina and Mexico are particularly illuminating in this regard. In the early 1990s, the two countries differed significantly in terms of inequality, poverty, the role of the middle class in the social structure, labour traditions, levels of social protection, labour market adjustment mechanisms and modes of insertion into the international economy. However, the profound, widespread deterioration of employment and the unprecedented levels of poverty

[1] Similar levels of inequality may produce different effects in terms of social exclusion, depending on the degree to which opportunities to do and obtain things are a function of income levels (Barry, 1998). Thus, when the quality of public health and education services is even throughout and high enough to be used by a large majority of the population, individual income becomes less relevant. As T.H. Marshall observed in 1950 (see Marshall, 1992), the extension of social rights is an instrument for the elimination of inequalities arising from social origin which influence the distribution of opportunities.

[2] The concept of social precarity comprises living conditions, work conditions and their mutual implications. Precarity of living conditions involves inadequate income, the duration of financial deprivation over time, its impact on housing, its corrosive effect on social, family and marital networks , etc. Precarity of work conditions involves the nature and quality of employment, and the implications these factors hold in terms of job satisfaction and prospects for mobility, learning, personal development and other issues (see Gallie and Paugam, 2002).

and inequality suffered by Argentina during the 1990s –which were made worse by the 2001 crisis– and the persistence and entrenchment of a highly segmented, inequitable social structure in Mexico have brought the two countries closer together, in terms of distributional inequity, than they were at the beginning of the decade.[3]

This article examines the main trends and manifestations of social decline in Argentina and Mexico during the 1990s from a multidimensional, comparative perspective, exploring the forms which the relationship between labour, unemployment, poverty and inequality have adopted in each case. Section II analyses both the integrative and exclusionary dynamics of the import-substitution industrialization strategy that prevailed in both countries –at varying rates and degrees of intensity– between 1950 and 1980. It notes that the disparities in the integration achieved during this period are key to understanding the dimensions and depth of the deterioration of working and living conditions which followed the model's dismantling. Section III highlights certain aspects that help to explain the various forms which labour market transformations can assume, noting the convergence of different elements, such as patterns of engagement with the international economy, labour traditions and their influence on the concepts and practices surrounding the idea of "work" and unemployment, and the various manifestations of the relationship between employment, unemployment, the informal sector and poverty in both countries.[4] Section IV explores the progressive hardening of the social structure in two key dimensions: inequality in the distribution of educational opportunities and the weakening of opportunities for social mobility through employment, particularly for sectors in the lower reaches of the occupational structure. The conclusions in section V highlight some of the main dilemmas and challenges which the transition towards more equitable, supportive and inclusive societies poses in terms of research and public policy.

II

Development strategies, employment and social integration: unfulfilled expectations, forgotten promises

Inequality and poverty are certainly not new to Latin America. An evaluation of the impact of different strategies or development models on the social structures of Latin American countries does, however, reveal differences in their capacity to achieve integration.

Until the 1980s, the relationship between economic growth and productive absorption of the labour force, as well as an incipient welfare regime (albeit a limited and imperfect one marked by significant disparities between countries and regions), fuelled the expectations

[3] During the first half of the 1990s, Argentina was in the middle of the scale among the countries of its region in terms of inequality in the distribution of income, according to the Gini coefficient. By the end of the decade, it had reached a high level of inequality (the joining the ranks of most of the other countries of Latin America). By 2002, it was (together with Brazil and Honduras) one of the most unequal countries in the region. Mexico remained among the group of countries with high levels of inequality between 1990 and 1999, moving to the middle of the scale in 2002 (ECLAC, 2004). The recent decline in the concentration of income in Mexico should be approached with caution. It is unusual, given the country's difficult economic situation, in which production has become stagnant and per capita income has dropped by 2.6% between 2000 and 2002. Changes have also been made in the sample design (size and distribution of the sample) and questionnaire of the 2002 National Household Income and Expenditure Survey, which makes comparisons with the 2000 survey difficult (see ECLAC, 2003, inset I.4).

[4] It should be noted that the research data available for both countries date from 2002 or earlier and cover a period of low economic performance in Mexico and full-fledged crisis in Argentina. This has specific implications for some of the problems addressed in this article –particularly in section III, subsection 2, which covers the informal sector and vulnerability, and explores the relationship between work precarity, unemployment and poverty. The lack of comparable, more recent data has restricted the author's ability to explore the behaviour of these variables in Argentina and Mexico beyond the stages of the business cycle.

of social mobility of large sectors of the population in Latin America. Urbanization, industrialization, the development of a public education system and the expansion of non-manual labour were expected to produce more equitable societies. Some countries came closer to fulfilling these expectations than others, where they became unfulfilled promises for large portions of the population.[5]

While the capacity for integration of the import-substitution industrialization model varied greatly among and within the countries of the region, the labour market was dominated by integrative trends, and formal employment was its point of reference.[6] Even though workers in the urban and rural informal sectors were excluded from welfare subsidies –mostly in the form of social security benefits– the degree to which they were excluded varied significantly within the region.[7] As Filgueira (1998) notes, these variations have been completely "forgotten" by the neoliberal critique of the import-substitution model –an oversight which has made it impossible to understand the diverse effects of the model's dismantling in Latin America. The decline that followed was certainly more marked and severe in countries which had achieved a greater degree of integration when the model was in force.

Table 1 compares some of the characteristics of the labour markets of Argentina and Mexico between 1950 and 1980. In Argentina, urbanization, industrialization and an increasing shift towards wage employment among the economically active population (EAP) emerged earlier than they did in Mexico and the rest of the region; formal employment also played a greater role in Argentina, and underutilization of labour –in terms of underemployment and unemployment– was lower.

TABLE 1

Latin America, Argentina and Mexico: Characteristics of the labour market in Latin America, 1950-1980

(In percentages of the Economically Active Population – EAP)

	Urban EAP	Salaried employment[a]	Manufacturing	Services[b]	Urban formal employment[c]	Under-employment[d]	Unem-ployment
Latin America							
1950	43.5	53.6	14.1	25.7	30.1	46.5	–
1980	64.0	58.9	18.3	38.2	44.6	42.2	–
Argentina							
1950	72.0	71.3	24.5	42.1	56.8	22.8	4.9[e]
1980	84.4	72.2	21.0	54.6	65.0	25.7	2.6
Mexico							
1950	34.5	51.1	11.2	20.4	21.6	56.9	7.0[e]
1980	61.5	63.4	19.0	36.1	39.5	40.4	4.5

Source: PREALC (1982) and ECLAC (1990).

[a] Data on salaried employment for 1950-1970 period.
[b] Services includes commerce, shipping and services.
[c] Defined by the Regional Employment Programme for Latin America and the Caribbean (PREALC) as those urban EAP categories not included in the urban informal sector.
[d] Defined as the sum of the urban informal sector (non-professional own-account workers, unpaid family workers and domestic workers) and traditional rural workers.
[e] 1970 figures.

[5] Different levels and rates of urbanization, industrialization and population growth, as well as the expansion of the public educational system, among other factors, created heterogeneous social structures in which the relative importance of the urban working class and the middle class varied from country to country. Consequently, while these classes generally had a stronger presence in Argentina and Uruguay in 1970 (20% manual agricultural labourers, 40% non-agricultural manual labourers and 40% middle and upper strata), the same could not be said of Mexico, where their presence was much lower (45%-30%-25%), and Brazil (50%-30%-20%). The size of these classes was extremely small in countries such as Guatemala (60%-30%-10%). See Gurrieri and Sainz (2003), p. 156.

[6] Although it never absorbed a majority of the workforce, formal employment grew steadily between 1950 and 1980, generating six of every ten new jobs. Thus, 40% of new jobs were in the informal sector, 15% were in the public sector and the remaining 45% were provided by mid-sized and large private businesses (Klein and Tokman, 2000, p. 18).

[7] For an analysis of the relationship between the informal sector and the development of social citizenship in Latin America, see Bayón, Roberts and Saraví (1998).

In Argentina (which, along with Uruguay and Chile, embarked on a development process quite early on and which pioneered the creation and expansion of a social security system) the integrative effect of import-substitution industrialization manifested itself in relatively low levels of social inequality, poverty and underutilization of labour. These levels remained steady until the mid-1970s, placing the country in a privileged position in Latin America.[8] This may be attributed to the convergence of several factors, such as slow population growth, higher levels of urbanization, a more rapid shift to wage-based employment and the early expansion of the public education system. Coverage in basic social services such as health and education was almost universal. The formal sector provided over 70% of wage employment (Marshall, 1998), and the informal sector –surrounded by a dynamic domestic market and a growing middle class– took on some quite unique characteristics. Unlike its counterparts in other Latin American countries, it was not a "refuge" or subsistence mechanism. On the contrary, it was made up of stable, self-employed workers with relatively high incomes, mid-level skills and moderate productivity rates. A significant percentage of this workforce had access to fringe benefits.[9]

While integration was less successful in Mexico, the country underwent profound, accelerated social and economic transformations during this period. Industrialization and urbanization came late, and advanced rapidly, transforming a basically rural and agricultural country into a predominantly urban, semi-industrial one.[10] Coverage in basic services, such as education and health care, expanded, but their quality was lower than in Southern Cone countries, and significant regional disparities –both quantitative and qualitative– emerged in their provision. The segmentation of social services increased, not only as a result of lower basic-service coverage, but also due to the expansion of the informal sector. Wage employment ratios fell, and the income and benefits associated with formal employment were not as significant as they were in early-development countries (see table 1). As of 1978, following a period of steady growth in State health-care coverage, social security institutions covered only 38% of the overall population –nominally– while 45% of the population, mostly in rural areas, received no cost-free or quasi-cost-free medical care (COPLAMAR, 1985).

Despite the reduction of inequality in the distribution of income that took place between 1963 and 1984, inequity in the distribution of the benefits of growth remained, even during the "golden years". By the end of the period, the wealthiest 20% of the population received over 50% of available income, and almost 6 out of every 10 Mexicans continued to live in poverty (Moreno Brid and Ros, 2004).[11]

The privileged position of Argentina began to gradually deteriorate in 1975. In less than three decades, the social structure of the country underwent a transformation without parallel in Latin America. Inequality and poverty increased, and earlier channels of social mobility were significantly weakened. These changes first began appearing in the mid-1970s, as the previous development model ran its course. During the 1990s, a new socioeconomic model emerged. The new model not only involved new patterns of insertion into the global economy, but also created new relationships between households and the labour market and the State, which shook the country's social structure to its roots.[12]

[8] Urban poverty levels in Argentina circa 1970 were between 4% and 5%, and the Gini coefficient of household income distribution was 0.41% between 1953 and 1961, compared to 0.52 in Mexico and 0.57 in Brazil (Altimir and Beccaria, 1999).

[9] Between the mid-1940s and 1970, the growth of small-scale commerce accounted for almost half of the growth of own-account activities, and almost 5 in 10 self-employed workers belonged to the middle class (Torrado, 1992). The low cost of repairs in relation to the price of consumer goods also contributed to the growth of own-account mechanical, electrical and electronic-appliance repair work among the working class during this period (Marshall, 1978).

[10] Between 1940 and 1980, the economy grew at an annual rate of 6.4%, and the share of manufacturing in GDP rose from 15.4% to 24.9%. The percentage of the population living in urban areas rose from 35% to 66%, and the overall population increased almost fourfold, from 20 million to 70 million. Literacy rates doubled, reaching 83%; average schooling among the adult population rose from 2.6 to 4.6 years, and life expectancy at birth rose from 24 to 65 (INEGI, 1985).

[11] According to Cortés (2000), the reduction in the concentration of income which took place between 1963 and 1984 (when the Gini coefficient dropped from 0.523 to 0.456) was due mainly to an increase in the relative share of the country's intermediate and lower deciles caused by a drop in the share of the wealthiest 10%. This trend was interrupted and reversed in later years, when the participation of the upper decile rose consistently.

[12] Between 1974 and 1991, the Gini coefficient rose from 0.36 to 0.447, reaching 0.51 in 2000. Income differences between the richest and the poorest decile tripled, and poverty levels increased fourfold. In 1974, the average per capita income of the richest 10% of households was 12 times that of the poorest 10%; in 1991 it was 23 times higher, and in 2000 it was 38 times higher. Poverty in Greater Buenos Aires in 1974 affected no more than 5% of households; this figure rose to 9% in 1986, and 25% in 1990

The occupational structure of Mexico underwent profound changes during the 1980s, beginning with the crisis of 1982. Their basic effect was to lower the more modern sectors' share of total employment, as informal employment (primarily self-employment and unpaid family work) increased. In absolute terms, informal employment increased by 80% between 1980 and 1987, absorbing 33% of the labour force by 1987 (ECLAC, 1989).[13] Instead of improving in 1988-1994, when the Mexican economy expanded moderately as a result of a new growth strategy, the shortfall of stable, adequately remunerated employment since 1982 –described by Lopez (1999) as a "structural imbalance"– worsened, as did inequity in the distribution of income. The Gini coefficient rose from 0.456 to 0.514 between 1984 and 1992, and the concentration of income in the richest 10% of the population rose from 34.2% to 40.5% during the same period (Cortes, 2000). A general overview of the 1990s reveals a transfer of income from the poorest households to the richest ones, with little variation occurring in the relative position of middle-income households. The country's entry into the North American Free Trade Agreement, the 1995 crisis and its after-effects not only slowed the growth of the population's purchasing power, but also tilted it in favour of the richest 10% at the expense of the real income of the rest of the country's households –especially the poorest 30% of the population. As a result, inequality levels in the year 2000 were similar to those of the 1960s (Hernández Laos, 2003).

This preliminary analysis is necessary in order to understand the extent and depth of the social decline experienced by Argentina and Mexico during the 1990s, as well as the disruptive impact of that decline on their social fabric. Roberts (2004) notes that, compared to other nations such as Brazil, the countries of Central America and Peru, the middle and working classes of Argentina and Uruguay face a much steeper decline in their living standards and a more dramatic reconfiguration of their employment opportunities. This situation is compounded by another important factor: the memory of better times. Unlike Argentina and Uruguay, the urban populations of many Latin American countries have no "golden" benchmarks in the past with which to evaluate present crises. They have always struggled for survival. This is a difference which affects not only political life, but also the formal and informal mechanisms employed to deal with crises (Roberts, 2004).

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following a bout of hyperinflation; in 1994 it dropped to less than 15% and climbed once again to 21% in 2000 (Damill, Frenkel and Maurizio, 2002; Beccaria, Altimir and González Rozada, 2003). Wage employment not registered with the social security system rose from 19% in 1974 to 27.3% in 1990, reaching 38% in 2000, while unemployment increased more than sevenfold, from 2.6% to 19% between 1980 and 2001 (Permanent Household Survey, National Institute of Statistics and Censuses).

[13] The discrepancies between these data on informal employment in Mexico in 1980 and the figures in table 1 arise from the fact that the latter were calculated based on the urban EAP, whereas the data obtained from ECLAC (1989) refer to the labour force as a whole.

III

The worsening of the labour market: a comparative overview

Despite the similarities between the economic policies applied in Mexico and Argentina –particularly during the first half of the 1990s (stabilization, trade and finance liberalization, privatization)– and the vulnerability of both countries to external disturbances, their labour markets adjusted very differently. Open unemployment, which stood at similar levels in both countries at the end of the 1980s, rose sharply in Argentina, whereas in Mexico it remained low (see figure 1).[14]

In Argentina, the evolution of employment, poverty and inequality indicators during the 1990s was convincing, painful proof of the country's progressive social decline. There was no European-style welfare regime in place to deal with drastic increases in unemployment, job insecurity and poverty, and the "cushions" or "escape valves" found in Mexico and other Latin American countries –namely, maquilas (offshore processing plants), migration and the informal sector[15]– were also either lacking or weak. In Mexico, these cushions helped keep unemployment relatively low, although they failed to improve living or working conditions for large segments of the population.

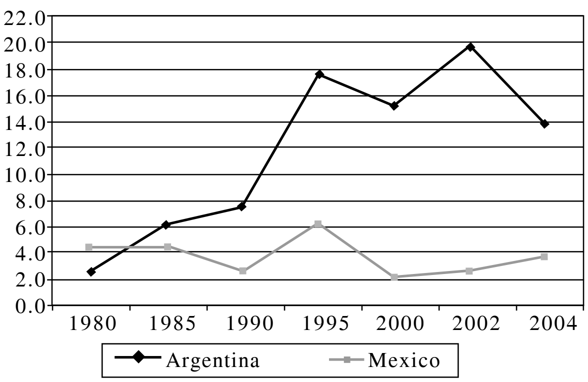
While working conditions deteriorated in both countries during the 1990s, the characteristics of their decline differed. In Argentina, the main –though certainly not the only– labour-market adjustment mechanism was unemployment, whereas in Mexico low unemployment was accompanied by a significant reduction in wages, coupled with growth in the informal sector. A low open unemployment rate, high levels of informal-sector employment, low wages and a low share of wages in GDP were among the distinctive characteristics of the Mexican economy (Lopez, 1999).[16]

In Argentina, where the labour market had traditionally been characterized by higher levels of formal employment and protection, the rapid growth of unemployment and precarious employment (underemployment and employment lacking social security benefits) was accompanied by a drop in the capacity of the informal sector to absorb labour, especially where self-employment activities were concerned. During the 1990s, save for 1996, when the aftershocks of the severe crisis of 1995 were being felt, unemployment rates in Mexico were actually the lowest

FIGURE 1

Argentina and Mexico: Urban unemployment, 1980-2004

(Average annual rates)[a]



Source: ECLAC (2004c and 2004d).

[a] Average annual rate of urban unemployment.

[14] Open unemployment has fallen substantially in Argentina since 2002, whereas it has been on the rise in Mexico since 2000; as of 2004, however, Argentina still possessed one of the highest unemployment levels in the region, while Mexico had one of the lowest.

[15] The issue of Mexican labour force migration to the United States lies beyond the scope of this article. It should be noted, however, that both this analysis and the manifestations of social decline in Mexico over the past few decades help to explain the forms migration has adopted as job opportunities contract and deteriorate, making it an increasingly complex and diverse phenomenon. In this regard, Canales (2002) emphasizes the need to view changes in the patterns and profiles of migration in the light of the social, economic and political transformations which have taken place in Mexico and the United States since the mid-1980s and which have significantly redefined relations between the two countries.

[16] In 2000, the real minimum wage was only one third of what it had been in 1980, and salaries and wages paid by the largest manufacturing enterprises had fallen to less than 40% of their 1990 levels (Salas and Zepeda, 2003, p. 65).

in the region. In Argentina, on the other hand, unemployment rose during the 1990s, even during periods of higher growth.

It has been repeatedly argued that low unemployment in Mexico can be attributed to the lack of an unemployment insurance system, as well as the scant saving capacity of the country's workers, who must accept any work available, or "invent" jobs where none exist. This is a relevant argument, which can be used, and empirically supported, to analyse conditions within the country's borders. It falls short, however, when the problem is approached from a comparative perspective. The issue certainly becomes more complex when one considers events in other Latin American countries –particularly Argentina, where unemployment not only rose sharply during the 1990s, but also had a disproportionately strong effect on the poorest, most vulnerable sectors (those with the lowest saving capacity and very limited access to unemployment benefits). In order to understand the multiple dimensions of the problem, three factors should be taken into account.

First, the points of comparison must be clarified. The lack of an unemployment insurance system might be a relatively valid explanation for low unemployment in Mexico, if that country were being compared to the European nations – although social protection systems in Europe are highly diverse, and the subject itself is widely debated.[17] It does not, however, explain why unemployment levels in Mexico are low compared to the rest of Latin America. The region's "real" unemployment insurance systems are sharply limited –in those countries where they exist– by very low coverage (in a setting where formal and stable employment is far from the norm) and low payments. An insurance system which never covered more than 6% of the unemployed population can hardly explain why upward of 20% of the EAP in Argentina has succumbed to unemployment during times of severe crisis, while unemployment in Mexico has never exceeded 6% (see figure 1).[18]

The second factor to consider is the link between poverty and unemployment. In Argentina, the strong relationship and feedback between these two phenomena cast doubt on the idea of unemployment as a "luxury" –enjoyed by sectors with higher levels of schooling and greater saving capacity– which the poor "cannot afford". While it is true that, from the 1990s onward, unemployment spread to all occupational categories and levels of schooling, it had a disproportionate effect on those who were most deprived in terms of education and skills. Statistics for Greater Buenos Aires show that unemployment among the poorest 10% of the population rose from 14.3% to 29.8% between 1990 and 2000 (Permanent Household Survey, INDEC).

The third, often overlooked, factor is the influence of labour traditions on the way in which work and unemployment are defined and experienced. These traditions serve as frames of reference that reveal the degree to which unemployment constitutes a clearly recognizable category. Qualitative data show that in Argentina (whose labour market has historically possessed some of the highest levels of formal employment in the region), the stability and rights associated with "work" not only affect perceptions of what constitutes a "good job", but also influence the very definition of work and social belonging, even in an environment of severe job insecurity (Bayón, 2002). Labour rights tend to be intertwined with the very concept of employment, even among low-income, unskilled workers who have never fully enjoyed those rights. The expression *changa*, which refers to odd jobs, is locally used to describe all those activities which "do not" constitute work.

In societies like that of Mexico, characterized by strong traditions and patterns of informal employment and consumption, where wage work has been less important historically, work tends to be associated more with income generation than with stability and protection, and the concept of unemployment is less

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[17] A comparative analysis of European Union countries shows little empirical evidence to suggest that welfare benefits –specifically, the existence of an unemployment compensation system– reduces incentives to work, or, to put it in other terms, stimulates unemployment. The issue is certainly more complex, and depends not only on the extent and monetary amount of the benefits provided, but also on the interaction of policies (for example, welfare benefits and active labour-market policies). See, among others, Esping-Andersen and Regini (2000) and Gallie and Paugam (2000).

[18] In Argentina, the National Employment Act of 1991 provides for an unemployment insurance system; it only applies, however, to stable employment, and is limited to certain segments of the formal sector. This explains its scant coverage during a period of extended job insecurity. Workers dismissed without cause from a registered job who have paid into the social security system for at least 12 of the 36 months preceding dismissal are entitled to unemployment compensation. The system applies to wage earners covered by the Employment Contract Act, and thus excludes construction workers (for whom a separate regime exists), domestic workers, and persons employed in the public and rural sectors.

recognizable to the population.[19] Several studies of Mexico (and daily urban life in that country) confirm that self-employment activities or, to put it in other terms, the ability to “invent” ways of generating income to cover household needs, is a family labour tradition among low-income groups (Estrada Iguiñiz, 1996). According to Selby, Murphy and Lorenzen (1994), poor city dwellers are more interested in providing their families with the resources needed to live than in holding a single, steady job. Expressions such as “trying to get by” (*buscando la manera*), “slaving away” (*haciéndole la lucha*), “hustling” (*poniéndose abusado*), etc., are vivid, gritty examples of the “whatever it takes” mentality of the urban poor.

While these three elements do not represent an exhaustive analysis of labour-market adjustments in the two countries under review, they do draw attention to the multidimensional nature of the problem. With the same objective in mind, we will now examine three dimensions that are key to understanding the different ways in which the labour market has deteriorated in Argentina and Mexico. The first dimension involves the relationship between changes in a country’s employment structure and the way it positions itself in the international economy. The second focuses on the problem of informal employment and lack of social protection. The third explores the various forms which the relationship between work, unemployment and poverty has taken in each country.

1. Export model and manufacturing jobs

The export structures of Argentina and Mexico reflect their contrasting positions within the international market. Argentina’s export sector is highly specialized in goods that require intensive use of natural resources, whereas Mexico is strongly geared towards manufacturing (both of the maquila and non-maquila variety). Primary goods accounted for 71% and 66% of Argentine exports in 1990 and 2001, respectively, while the share of manufacturing –most of it labour intensive– in Mexican exports increased from 43% to 85% during the same period (UNDP, 2003).

This pattern of specialization has had different effects on job creation, especially in the manufacturing sector. Argentina underwent a significant de-industrialization process in the mid-1970s, and the number of jobs provided by its manufacturing sector shrank, with manufacturing employment falling by 66% between 1976 and 2001. During the 1990s, trade liberalization and currency overvaluation radically transformed the relative prices of labour and capital. This shift had a negative impact on labour demand in the tradable goods sector and encouraged the substitution of capital for labour, which led to a strong gain in productivity.[20] Those businesses that were able to survive increased their investment in capital assets, cutting their payrolls even during the brief expansion of 1991-1994. To this was added the loss of jobs resulting from the shutdown of small and medium-sized industrial enterprises and the implementation of labour-saving measures without additional investment in fixed assets. Despite high economic growth in Argentina during the early 1990s (mainly between 1991 and 1994), unemployment grew almost without interruption from 1991 onward (Katz, Bisang and Burachik, 1995; Heymann, 2000).

Between 1991 and 1999, manufacturing employment in Argentina fell by 46.6%, whereas in Mexico it rose by 28.8% (Stallings and Weller, 2001). This reflects the “cushion” effect of the Mexican maquila industry –whose share of industrial employment rose from 14% to 30% between 1990 and 2000– in the face of manufacturing job losses in other sectors. However, the boom in maquila jobs, which doubled in just five years, from 650,000 in 1995 to almost 1,300,000 in 2000, is beginning to show signs of tapering off. Almost 230,000 such jobs have been lost in only three years (between 2000 and 2003), and the share of manufacturing in urban employment has dropped from 29.3% to 26% (INEGI, 1985; ILO, 2004).

The displacement of manufacturing-sector workers and the increase in the labour supply in Mexico were absorbed primarily by an expansion of employment in the service sector, where the number of full-time jobs increased, especially in activities characterized by a greater predominance of informal work, such as commerce. This sector accounted for one of every four new jobs created during the 1990s (Frenkel and Ros, 2004).

Argentina outpaced Mexico in terms of manufacturing job loss, while full-time employment

[19] Gallie, Jacobs and Paugam (2000) note that, in the south of Italy, the prevalence of labour precarity has altered the way unemployment is perceived and experienced, as well as future work expectations, since the informal economy is the primary means of coping with poverty and job insecurity.

[20] After Argentina devalued its currency at the end of 2001, employment in this sector surged, growing 16% between 2002 and 2004 (*Encuesta Industrial Mensual*, INDEC).

in almost all of its non-tradable goods sectors –with the partial exception of financial services, communications and transportation– remained stagnant between 1991 and 2000. Consequently, employment in these sectors failed to offset job losses in other sectors of the economy. The main result of strong employment in the service sector was a steady increase in underemployment.[21] Underemployment in Greater Buenos Aires, which rose from 8.3% to 15.1% between 1990 and 2000 and reached 16.8% in 2004 (Permanent Household Survey, INDEC), was one of the clearest manifestations of the deterioration of the labour market in terms of income and job insecurity.[22] The loss of full-time manufacturing jobs was partially offset by underemployment in the service sector, which, given its countercyclical nature, played a similar role to that of the informal sector in Mexico (Frenkel and Ros, 2004).

2. Informal employment and lack of social protection

In Argentina, high levels of unemployment were accompanied by a slowdown in self-employment, which increased the vulnerability of large groups of workers –particularly middle-aged persons with little schooling– to exclusion from the labour market.[23] In Argentina, the share of informal employment accounted for by self-employed work fell from 22.9% to 17.5% between 1990 and 2002, as shown in table 2, whereas in Mexico it rose from 19% to 21% during the same period. The contrasting behaviour of self-employment in commerce and services in the two countries is particularly striking: it dropped from 16% to 10.7% in Argentina, and rose from 12.5% to 16.1% in Mexico.

During the 1990s, unlike previous decades, the growth of salaried employment in Mexico lost momentum. The share of wage employment in the employed EAP dropped from 76.4% to 73.1% between 1989 and 2002.[24] The reduction of the public sector's share of wage employment –from 16.1% to 13.2% between 1994 and 2002– and a drop in employment among businesses with more than five workers –from 48.1% to 32% during the same period– help to explain the slowdown (ECLAC, 2003). Employment grew faster in those sectors which had traditionally been the most precarious –microenterprises, domestic work and unskilled self-employment. As of 2002, these sectors accounted for almost half of the urban employed population. In other words, 5 out of every 10 Mexican workers are "integrated" into the most precarious segments of the labour market, where the lack of social protection reaches alarming levels: only 1 in 10 workers in the informal sector has access to retirement benefits (see table 3). Informal workers are not, however, the only ones lacking fringe benefits; according to statistics for 2000, 4 out of 10 wage workers in the formal sector (employed by larger businesses or in the public sector) do not have those rights. As a result, in Mexico (the country with the lowest unemployment levels in Latin America), a large majority of workers lack social protection. The situation has worsened in recent years: the employed population (both wage earners and others) without access to welfare benefits rose from 61.4% to 63% between 2001 and 2004, reaching 64% during the first quarter of 2005.[25]

Table 3 shows the degree to which the employment situation deteriorated in Argentina during the 1990s. Despite the unprecedented intensity and scope of job insecurity during that period, several indicators show that Argentina still possessed stronger social protection mechanisms than Mexico. The most visible differences between the two countries involve retirement benefits or pensions for persons over the age of 65 (68.7% coverage in Argentina, compared to 20%-25% in Mexico), access to health insurance through employment (61% and 39%, respectively) and severance compensation for wage earners (56%, compared to 20%).

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[21] Underemployed persons are those who work fewer than 35 hours a week for reasons beyond their control and who wish to work more hours.

[22] As of October 2000, 7 of every 10 part-time workers were underemployed, and 71.4% lacked access to fringe benefits (Permanent Household Survey, INEGI). While the real average income of full-time wage earners rose by 17%, that of underemployed workers fell by 15% between 1991 and 2000 (Damill, Frenkel and Maurizio, 2002).

[23] This slowdown in self-employment can be attributed to the disappearance of numerous small stores and repair shops that were unable to compete with large supermarket chains and a massive influx of imported goods, as well as diminishing employment opportunities in certain services (such as repair work, due to an increase in access to credit for the purchase of durable consumer goods at the beginning of the decade), among other factors.

[24] Between 1970 and 1990, wage employment increased by 154%, and own-account employment rose by 87%. Wage employment became the norm only in the manufacturing sector, however, since non-wage employment continued to predominate in commerce and, to a lesser degree, the service sector (Rendón and Salas, 2000).

[25] INEGI (2001, 2004 and 2005).

TABLE 2

Argentina and Mexico: Employed population in the informal sector, 1980-2002
(As percentages of total employed urban population)

		Micro-enterprises			Self-employed unskilled workers		
	Total	Employers	Salaried workers	Domestic work	Total	Manufacturing and construction	Commerce and services
Argentina							
1980	48.9	2.6	10.2	3.9	32.2	6.5	25.7
1990	44.4	3.8	12.0	5.7	22.9	6.9	16.0
1997	41.4	3.7	15.9	5.1	16.7	4.6	12.1
2000	42.2	3.4	16.0	5.3	17.5	5.1	12.4
2002	42.1	2.9	16.1	5.6	17.5	6.8	10.7
Mexico							
1984	…	…	…	2.6	24.7	2.1	14.0
1989	…	…	…	2.7	18.9	3.0	12.5
1996	43.7	3.8	15.8	3.6	20.4	3.8	15.7
1998	44.3	3.9	15.9	4.1	20.4	3.2	16.4
2000	42.5	3.9	16.0	3.0	19.6	3.6	15.1
2002	47.2	3.4	18.3	4.6	20.9	4.2	16.1

Source: Panorama social de América Latina (ECLAC, various years).

TABLE 3

Argentina and Mexico: Selected social protection indicators, 1990-2001
(Percentages)

	Salaried workers entitled to retirement pensions			Over 65, with access to retirement benefits or pension	Salaried workers with access to health insurance through employment	Salaried workers entitled to severance compensation	Unemployed persons covered by unemployment compensation
	Formal sector a	Informal sector b	Total				
Argentina							
1992	86.6	34.6	70.6	76.1	67.5	67.0	
1996	82.2	30.0	66.3	73.4	63.0	60.0	2.7
2001	79.4	24.7	63.0	68.7	61.0	56.0	3.6
Mexico							
1996				17.9[c]			
				22.0[d]			
2000	63.0	12.1	47.6[c]	19.0[c]	39.0	20.0[c]	
			53.0[d]	24.6[d]		22.0[d]	

Source: ILO (2003); Gasparini, 2004.
[a] Salaried workers employed by businesses with more than five workers and the public sector.
[b] Salaried workers employed by businesses with five or less workers.
[c] National total.
[d] Urban total.

Higher levels of social protection in Argentina conceal significant inequities in their distribution. According to a living conditions survey (*Encuesta de Condiciones de Vida*) conducted in 2001, 64.2% of the population over 65 was covered by some type of contributory or non-contributory retirement plan. This percentage was halved, however (32.2%), among the poorest 20% of the population; coverage in the second quintile was 57.2%, and in the highest quintile it was 78.5% (ILO/MECON, 2005).

3. Labour precarity, unemployment and poverty

The relationship between job instability, poverty and lack of social protection manifests itself differently in each case. Some authors argue that, in general terms, to be a worker in Latin America is equivalent to being poor; thus, one need not be unemployed to be below the poverty threshold (Portes and Hoffman, 2003). The Mexican and Argentine experiences, however, entail significant nuances that help to explain the specific characteristics of the problem in different contexts.

The relationship between employment and poverty in Mexico and Argentina –at least until the late 1990s– was particularly lopsided. As shown in table 4, the most dynamic segments of the labour market in Mexico were precisely those with the highest levels of poverty and lack of access to social benefits. In 2002, urban poverty affected 32% of the urban population and 25% of the employed. It reached 40% among wage earners employed by microenterprises and 46% among domestic workers. Among salaried workers employed by businesses with more than five workers and non-professional self-employed workers in the industrial and construction sectors (segments which comprise half of the employed urban EAP), it reached 27%.

While poverty levels among the overall population of Argentina surpassed those of Mexico in 2002, poverty among the employed was similar in both countries. This suggests a stronger relationship between employment and poverty in Mexico and a higher level of unemployment among lower-income sectors in Argentina. Consequently, while one need not be unemployed to be poor in Argentina, the poor are particularly vulnerable to unemployment, as illustrated by the employment profile of poor households in both countries (see table 5). Although poverty among the employed is lower in Argentina, it should be noted that, between 1999 and 2002, it grew at a faster rate than it did for the population as a whole. As a result, the low wages typical of jobs generated during this period may be moving Argentina closer to the trends observed in Mexico. The two countries have thus been levelling downward as a result of deteriorating employment conditions in Argentina, rather than any improvement in Mexico.

The employment profile of poor households shows a rise in participation rates in both countries, although the increase was greater in Argentina. While participation rates were similar in both countries in 2002, poor households in Argentina displayed lower levels of occupational density and higher unemployment, as well as a marked deterioration in the average income of employed household members. The strategy of sending more members of the household into the labour market yielded different results in each country. In Mexico, it increased the occupational density of poor households, albeit at very low-income levels. In Argentina, the strategy was much less effective, and increased the number of unemployed household members (see table 5). A lack of work has

TABLE 4

Argentina (urban areas) and Mexico: Poverty in selected occupational categories, 1990-2002

(As percentages of total employed urban population)

			Non-professional, non-technical salaried workers in the private sector			Non-professional self-employed workers	
	Total population	Total employed population	Businesses with more than 5 workers	Businesses with up to 5 workers	Domestic work	Industry and Construction	Commerce and Services
Argentina (Greater Buenos Aires)							
1990	21	10	…	15	21	6	8
1994	13	5	…	7	10	4	3
1997	18	8	12	18	8	6	
1999	20	10	9	17	22	14	3
2002	42	27	31	40	43	31	19
Mexico							
1989	42	33	…	…	60	32	28
1994	37	29	…	…	56	…	…
1996	45	38	41	59	63	48	41
1998	39	31	36	49	57	39	30
2000	32	25	26	44	38	34	24
2002	32	25	27	40	46	27	21

Source: ECLAC (2003).

TABLE 5

Argentina (urban areas) and Mexico: Labour profile of poor households, 1990-2002
(Percentages)

	Poverty rate	Average size of household	Participation rate [a]	Unemployment rate [b]	Occupational density [c]	Median income of employed persons [d]
Argentina						
1990	16.2	4.51	0.47	…	0.16	2.5
2002	31.6	4.5	0.64	0.26	0.25	1.57
Mexico						
1990	39.0	6.03	0.58	…	0.29	1.6
2002	31.8	5.1	0.65	0.03	0.35	1.33

Source: ECLAC (2004[a]).

[a] Economically active population (EAP), including employed and unemployed/Working-age population.
[b] Number of unemployed/EAP.
[c] Number of employed/Number of members in the household.
[d] Expressed as a fraction of the value of the poverty line.

thus been added to the problem of precarious work (work that is unstable, low-paying, unprotected, etc.). The problem is not simply a shortfall of income, but also an absence of income due to continually shifting, precarious employment and recurring joblessness.

Table 6 makes it possible not only to explore the labour characteristics of poor households in Mexico and Argentina, but also to compare their employment status with that of households above the poverty line in both countries. Poor households in Argentina faced severe unemployment in 1999-2003; 35.7% included at least one unemployed member, and one in four households included at least two unemployed members. In Mexico, on the other hand, these percentages were below 6% and 1%, respectively. A comparison of poor and non-poor households shows that, in Argentina, the presence of at least two employed persons in the home helped to reduce its exposure to poverty; this was the case in almost 40% of households above the poverty line, compared to only 25.5% of poor households. In Mexico, on the other hand, 46.5% of poor households and 51.9% of non-poor households included at least two employed members –a difference which does not appear to be significant. The higher participation rate for employed persons from lower-income households in the informal sector is the most visible difference; while not all informal-sector workers are poor (participation in this sector is high among members of non-poor households), most of the members of non-poor households are employed in the informal sector.

TABLE 6

Argentina (urban areas) and Mexico: Labour characteristics of poor and non-poor households, 1999-2003
(Percentage of households by employment situation of members)

	At least 1 employed person	At least 2 employed persons	At least 1 unemployed person	At least 2 unemployed persons	Inactive head of household	Persons working in the informal sector
			A. Non-poor households			
Argentina	76.9	39.2	14.2	1.2	30.7	39.8
Mexico	92.1	51.9	3.9	0.7	16.2	51.3
			B. Poor households			
Argentina	76.6	25.5	35.7	9.2	23.3	47.3
Mexico	93.1	46.5	5.3	0.9	13.9	69.7

Source: ECLAC (2004a).

IV

Unequal distribution of opportunities and entrapment in disadvantaged situations

The above analysis of the relationship between poverty and the various manifestations of labour precarity shows a gradual erosion of the mechanisms that had previously ensured economic survival and allowed people to earn an income. The possibility of "making a living" by working, at least in a steady job, has become increasingly uncertain.

The severely diminished role of work and education as channels for social mobility –or at least as a basis for expectations of future improvement– and growing inequities in the distribution of job and educational opportunities are indications that the social structure is becoming increasingly rigid. In other words, the manoeuvring room for overcoming disadvantageous situations for persons from underprivileged households –in terms of income, employment, education, housing and other aspects– is shrinking as the environment becomes more and more hostile towards those who do not possess strong cognitive abilities and social skills. The lack of these resources leads to entrapment in life chances marked by a "spiral of precariousness" (Paugam 1995), where disadvantages accumulate and reinforce each other.

These processes were manifested even more harshly after the social reforms adopted during the 1990s, which were not only a correlate of adjustments in the economic sector but also increased the vulnerability of large sectors of the population. Universal coverage of State health and education services was found to be inefficient, as it favoured middle-income sectors at the expense of lower-income ones. Targeting strategies were implemented to change this distributional "bias" and decentralize services. The result of this effort was what Bustelo (1992), quoting an expression coined by Fernando Henrique Cardoso, described as the "*Estado de malestar*" ("badfare State"), which led to the dismantling of programmes in which the incipient welfare State had achieved some degree of progress. The psychosocial dimension of this phenomenon was evident in the freezing of prospects for upward mobility, the loss of expectations for an improved quality of life and a dogmatically individualistic ethos in which everyone was left to his or her own fate in an atmosphere of growing social polarization (Bustelo, 1992).

1. Hardening of the social structure

(a) *Unequal distribution of educational opportunities*

The distribution of educational opportunities is one of the clearest signs of the widening gap that separates the privileged from the underprivileged. This inequity is especially significant in an environment in which access to knowledge is a key to opening up the opportunities offered by ongoing processes, and the lack of such access increases and accelerates the processes of exclusion that affect the more vulnerable sectors.

Reimers (2000) lists five processes whereby disparities in income distribution lead to disparities in educational opportunities in Latin America. They are: (i) differential access for the poor and non-poor to different levels of education; (ii) differential treatment of the poor and non-poor in school, whereby the former receive a lower-quality education; (iii) the growing tendency of students to associate only with peers of the same socioeconomic background; (iv) the contribution of parents to their children's education, with better-educated parents contributing more; and (v) the existence of educational curricula and processes that are not specifically designed to reduce inequality.

The relationship between income distribution and distribution of educational opportunities helps to explain the importance and social value traditionally attached to education in Argentina and Mexico, given its potential for fostering integration and promoting social mobility.[26] Around the mid-1990s, a reverse

[26] In Latin America, the educational Gini coefficient (which measures inequality in the distribution of education) was 50.1 in 1960, 47.0 in 1970, 43.1 in 1980 and 41.8 in 1990. During the same period, these coefficients in Argentina were 34.4, 31.1, 29.4 and 27.3, and in Mexico they were 56.0, 51.0, 49.7 and 38.4 (World Bank, 2003). These figures reflect the higher level of educational equity that has historically characterized Argentina in the region.

relationship existed between the distribution of educational opportunities and income distribution in the two countries. Argentina ranked first among 19 Latin American countries in terms of educational equity and fifth in income distribution, whereas Mexico ranked twelfth and eighth, respectively (Reimers, 2000, table 4.1). In other words, in Argentina the social gap, in terms of income, has historically been wider than the educational gap, whereas in Mexico marked differences in income distribution are accompanied by even greater inequality in the distribution of educational opportunities. This helps to explain the key role played by the extension of public education in Argentina as a promoter of social mobility and a source of integration and social belonging. The role of education in this regard is much weaker in Mexico, where the wide educational gap between high- and low-income sectors, the high degree of segmentation in terms of the quality of education and the very low educational levels of the poorest 40% of the population are dramatic indicators of the abysmal social differences that characterize the Mexican social structure (see table 7).

Here again, the disruptive impact of the neoliberal economic model has been deeper in Argentina, where the educational gap between the richest 20% and the poorest 20% of the population widened even more than in Mexico, rising from 4.7 to 6.1 (see table 7). The deterioration of educational levels in the poorest quintile in Argentina is significant since, rather than improving, they actually became slightly worse. This would appear to reflect not only a growing segmentation of the social structure, but also the stagnation of educational opportunities for the poorest sectors.

Although in general terms the region is moving towards an improvement in access to primary education for the poor, disparities remain –or have become sharper– precisely in those levels that are crucial to social mobility. Educational credentials play a more and more decisive role in determining access to "good" jobs, which are increasingly scarce. The higher schooling levels of the active population have led not only to a gradual devaluation of education, but also to increased exclusion of the less-educated sectors, whose job opportunities have deteriorated significantly. As the educational level of the population has improved, the minimum years of schooling required to obtain a job that pays wages above the poverty threshold has risen. Although a complete secondary education –or the equivalent of 12 years of school– is the minimum level required, it is becoming inadequate due to the increasing importance attributed to the quality of education. Years of schooling no longer constitute a passport into modern jobs; the "password" appears to be based on the provenance of educational credentials and the social capital of an individual's family (Filmus and Miranda, 1999).[27]

The gaps are widest at the secondary and tertiary levels. Increased educational coverage has failed to reduce differences between young people from different social strata. Disparities in educational opportunities become more pronounced from the age of 13 onward (see table 8). It is interesting to note that, in Mexico, the percentage of young people between the ages of 13 and 19 from the poorest deciles who were attending school remained practically stagnant between 1992 and 2002 (having risen from 55.6% to 57.6%), whereas in the top two deciles it rose from 80.7% to 92.8%. In both Argentina and Mexico, despite the improvements noted during the 1990s, the gap in the 20-24 age group increased sharply. In 2002, school attendance among the richest 20% was triple that of the poorest 20%.

According to data for the year 2000, among urban youth aged from 20 to 24 –regardless of whether or not they were better educated than their parents– there were 38% in Argentina and 46% in Mexico who did not

TABLE 7

Argentina and Mexico: Years of schooling in the adult population[a], by income quintile. 1992-2001

	1992		2001	
Quintiles	Argentina	Mexico	Argentina	Mexico
1	7.5	2.7	7.3	3.5
2	8.0	4.1	8.3	5.3
3	8.7	6.6	9.2	8.1
4	9.8	6.6	10.6	8.1
5	12.2	10.0	13.4	11.6
Average	9.5	6.1	10.1	7.4
Educational gap (Q5-Q1)	4.7	7.3	6.1	8.1

Source: World Bank (2003).
[a] Population aged 25 to 65.

[27] Between 1999 and 2003, only 6.4% of poor heads of household in Mexico and 17.8% in Argentina had received more than 12 years of schooling. In more than half of poor Mexican households, the head of household had received less than six years of schooling (ECLAC, 2004a).

TABLE 8

Argentina and Mexico: School attendance in urban areas, by household per capita income quintile and age group, 1990-2002
(As a percentage of the population in the same age group)

	Ages 7-12			Ages 13-19			Ages 20-24		
	Total	20% Lowest	20% Highest	Total	20% Lowest	20% Highest	Total	20% Lowest	20% Highest
Argentina									
1990	98.4	97.9	100	68.8	62.6	79.3	23.6	12.4	39.8
2002	99.4	99.1	100	83.2	76.3	96.4	40.6	21.7	61.6
Mexico									
1992	97.4	95.8	99.5	62.7	55.6	80.7	23.9	7.1	47.3
2002	98.1	96.3	99.6	68.9	57.6	92.8	30.7	16.4	55.1

Source: ECLAC (2004a).

have access to the basic educational capital[28] needed to aspire to a relatively well-paid job (ECLAC, 2004b). This is an indicator of the serious initial disadvantages that beset young people from low-income households as they try to enter the labour market. It also explains why they are likely to become entrapped in inferior opportunities throughout their life courses and how this situation is likely to be reproduced across generations.

The persistent linkage between access to education and a person's social stratum of origin suggests that, to a large extent, the opportunities for well-being that are currently available to young people have already been determined by the pattern of inequalities that prevailed in the previous generation. This translates into a rigid social structure with little social mobility (ECLAC, 2004b, p. 192).

(b) *The weakening of the role of work as a channel for social mobility*

With regard to opportunities for occupational mobility, some recent studies in Mexico and Argentina show that persons working in occupations requiring lower skill levels have little chance of improving their situation and are likely to become entrapped in the most precarious situations.

In their analysis of intergenerational social mobility in urban areas of Mexico, Cortés and Escobar Latapí (2005) note that, compared to the import-substitution industrialization stage (before 1982), opportunities for social mobility declined for all strata during the economic restructuring period (1988-1994). The impact was much more pronounced, however, among the lower income strata – unskilled industrial workers, informal workers in the service sector, *ejidatarios* (farmers who work on community land), small rural landowners and day workers. The authors note that under the new economic model, there was a widening of the differences in opportunities available to the lower classes and to the upper class – professionals, civil servants and employers of more than five workers. Thus, as inequality has increased, the system of occupational mobility has become less flexible, and the occupation of an individual's father has become a stronger predictor of the occupation that person will have (Cortés and Escobar Latapí, 2005).

In Argentina, Kessler and Espinoza (2003) have noted two particularly important aspects of emerging patterns of social mobility during the 1990s. First, as in Mexico, there has been a blocking of opportunities for upward occupational mobility among the most disadvantaged sectors. To this must be added the changes that have occurred in the occupational structure – a relative increase in the availability of jobs requiring skill levels that can only be filled by middle-income sectors, coupled with a drop in the number of jobs that can be filled by low-income sectors. Another element is the need to redefine the meaning of social mobility in the current economic environment. The authors discuss the experiences of workers who appear to have achieved upward occupational mobility in recent years and point to the disconnect between the improvement in job prestige and the social rewards that used to be associated with those jobs; thus, a process of "spurious mobility" appears to be taking place.[29]

[28] Completion of at least 12 years of schooling.

[29] There has been a change in the functional relationship among education, occupation and income and in how one factor

V

Conclusions

The above analysis provides a better picture of the forms which the relationship between income distribution and social exclusion assumes in Latin America. High inequality in the distribution of educational and occupational opportunities –and, hence, of social protection– provide stark evidence of the fact that income levels play a key role in determining the degree of access to social services and, more and more, the quality of the services received. This has led to a growing polarization and segmentation between first- and second-class citizens. The household into which a person is born is an increasingly strong predictor of the position he or she will have in the social structure. Initial advantages or disadvantages are not only maintained –and deepened– over a person's life course, but also tend be reproduced across generations.

This entrapment in cycles of deprivation – in terms of education, employment, income, housing, social networks – or, in other words, the increasing difficulties faced by the most disadvantaged sectors in trying to escape those cycles, sheds light on the exclusionary effects of the neoliberal model adopted by Latin American societies –at different rates and to varying degrees– over the past two decades. These societies are characterized not only by greater inequities and segmentation, but also by more rigid social structures and fewer opportunities and expectations of social mobility.

The integrative capacity of import-substitution industrialization fuelled the hopes of broad sectors of the population, who believed that "by working long and hard" they could improve their prospects, own a house, gain access to better educational opportunities for their children, build a life for themselves – in short, aspire to "a better future". This optimism gradually began to wane in the 1980s, and the 1990s brought a definite break with the "past". The devastating effects of the fiction of a self-regulating market on the social fabric (Polanyi, 1957) became especially evident when existing social protection mechanisms were dismantled, without any policy in place to prevent or mitigate the social costs of adjustment policies and economic restructuring processes.

The relationship between job instability, poverty and a lack of social protection during the period under review was manifested in different ways in Mexico and Argentina. In Mexico, low income levels and a high degree of labour precarity cast doubts on the efficacy of increasing the number of earners in the household as a safeguard against poverty. In other words, greater occupational density, in and of itself, does not make a household less vulnerable to poverty; the quality of people's employment, which is highly stratified, is the decisive factor. In Argentina, the marked labour deterioration was accompanied by high levels of unemployment, which affected the entire employed population but had the most serious impact on the most vulnerable sectors, given their job precarity and low educational levels. Moreover, persistently high unemployment levels –notwithstanding the considerable decline experienced from 2002 onward– may indicate a rise in poverty among the employed population of Argentina. This suggests that in Argentina, as in Mexico, employment is gradually losing strength as a means of escaping poverty.

Employment, as this analysis of Argentina and Mexico shows, is not only an increasingly scarce commodity, but also a poor-quality one. Access to better occupational opportunities is strongly determined by abilities and cognitive skills to which large sectors have no access. In such a context, highly segmented and polarized patterns of integration and belonging emerge, become consolidated and deepen. This multiplicity of disadvantages can hardly be addressed using approaches and policies that confine social problems to sectors living in extreme poverty, and thus contribute to the deepening of dualism and social segmentation, as well as the spreading of vulnerability to all those sectors that are not part of the target population and have no chance of gaining access to the protection systems provided by the market.

influences the others. Education does not necessarily help a person obtain a better job, and having a better job does not guarantee a better income. Given the general deterioration of working conditions, it is quite likely that jobs that had traditionally ranked high in the occupational structure are actually of poorer quality than in the past (Kessler and Espinoza, 2003).

As Esping-Andersen (2002) has noted, the key to guaranteeing people's well-being is not simply to focus on those sectors whose income levels are below the poverty threshold and/or who live in precarious conditions *at any given moment*. The highest priority must be to identify those groups that are most likely to *persistently* remain in low-income jobs and precarious living conditions. A comprehensive and dynamic approach is therefore required, both to address the problem and to devise public policies that will help anticipate and forestall disadvantageous situations before they become irreversible.

The dilemmas and challenges posed by the transition to more equitable, socially supportive and inclusive societies and the need to rethink the definition of social protection call for the adoption of a more complex and dynamic approach. A new perspective is needed both to better understand how the "social question" is manifested in the new context and to formulate and implement public policies that represent a departure from the fragmented, uncoordinated policies of today and their often contradictory effects.

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The Fiscal Covenant in Guatemala: lessons learned from the negotiations

Juan Alberto Fuentes K. and Maynor Cabrera

Guatemala's recent experience in negotiating a fiscal covenant, together with other efforts –some more successful than others– to achieve social covenants on fiscal policy, may serve as a lesson or suggest key elements for a fiscal covenant. This article analyses the Guatemalan experience in the light of the main determining factors of a number of successful or failed fiscal covenants in countries as diverse as Chile, Indonesia, Poland, the Russian Federation, Sweden, the United Kingdom and the United States. In conclusion, the authors identify 10 key components of a successful fiscal covenant, based on Guatemala's experience and that of the other countries mentioned above.

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I
The institutional framework of Guatemalan fiscal policy prior to the adoption of the Fiscal Covenant of 2000

Successive governments throughout Guatemala's history have been obliged to undertake tax reforms to deal with the inherent weakness of the country's public finances. It would seem that each administration has "discovered" this weakness and attempted to resolve it without fully understanding its nature or the major challenges that it raises. These initiatives have come up against very strong and well-organized interest groups, united in a confederation of business chambers, the Coordinating Committee of Agricultural, Commercial, Industrial and Financial Associations of Guatemala (CACIF), which has generally had direct access to the Executive and has been able to wield considerable influence over tax policy.[1] The direct and institutionally unmediated relationship between the economic powers and the Executive has taken two forms: (i) negotiation by elites, which has been reflected in a few minor tax reforms agreed between a technocratic elite and a business elite; or (ii) confrontation, a situation in which the private sector has resorted to lockouts, mobilization of public opinion through the media or the filing of complaints of unconstitutionality to invalidate by legal means possible increases in taxes.

Some articles of the 1985 Constitution weakened the position of the fiscal authorities and strengthened that of taxpayers. For example, a taxpayer wishing to contest tax resolutions cannot be required to pay the tax in advance, and the fines and interest on arrears must not exceed the value of the unpaid or overdue tax, since the Constitution deems this to be confiscatory. According to ECLAC, these clauses reflect the fact that in Guatemala, property rights are mixed with tax obligations, which does not occur in other countries such as El Salvador or Costa Rica.[2] Furthermore, the Constitution prohibits double taxation in very vague terms, which has given rise to multiple interpretations of this clause so that it is difficult to determine whether tax reforms adopted by Congress are applicable or not.

The Constitution also allows any citizen or company, with the assistance of three lawyers, to file a complaint before the Constitutional Court –the highest court on matters relating to the Constitution of Guatemala– which may, if it considers that a law infringes any constitutional right, declare it invalid. According to ECLAC, this means that the negotiation of taxes is tantamount to a "direct negotiation between the State and the propertied classes", whereas in other countries, such as Costa Rica or El Salvador, it is in the Congress and in the political arena that the tax authority of the State is defined (ECLAC, 1996).

Consequently, tax negotiations are not concentrated principally on the approval of legislation by Congress, since such approval can be changed relatively easily by the Constitutional Court if a complaint of unconstitutionality is filed. In this new context, governments may be faced with a reduction of their financial resources when least expected, as occurred in 1994, when the tax burden was reduced by 1% of GDP because a tax law was declared unconstitutional.

Table 1 lists the various initiatives launched between the 1980s and the year 2000 (when the Fiscal Covenant for a Future of Peace and Development was signed), together with the private sector's response and the final outcome of the initiative. Three conclusions are evident. First, situations of confrontation predominated, with CACIF asserting its "veto power" through lockouts, denunciation campaigns in the media, and the filing of complaints of unconstitutionality (which occurred irrespective of the type of government: regardless of whether it was military or civil and whether it had a majority in Congress or not).

When negotiations did take place, they took the form of "elite negotiations" between a technocratic elite and business leaders; the real forum for negotiations was not the democratic institutions of the

[1] See McCleary (1999, p.108), Valdez (2000, p.12), Martí and Ortiz (1993), Valdez and Palencia (1998), Urrutia (2000) and Palencia (2002).

[2] For a comparative analysis, see ECLAC (1996).

TABLE 1

Guatemala: Summary of tax reforms and their results, 1980-1999

Government and year of reform	Government proposals	Form of action used by CACIF	Outcome	Change in tax burden
		Cases of confrontation		
Military regime with internal armed conflict				
Ríos Montt (1983)	10% value added tax (VAT) Elimination of export duties Regulations on customs valuation Luxury tax	Support of the Chamber of Commerce for VAT in exchange for non- approval of the regulations on customs valuation and the luxury tax. Anti-tax campaigns in the media	Adoption of VAT and elimination of import duties	-1.9% (between 1982 and 1984)
Mejía Victores (1985)	Reduction of VAT to 7% Tax on coffee Expansion of the VAT base Amendment of the tax on petroleum derivatives	Opposition to measures Anti-government campaigns in the media Repeal of laws	Dismissal of the ministers of the economy and public finance	1.7% (between 1984 and 1986
Democratic regimes with internal armed conflict				
Vinicio Cerezo (1987)	Temporary tax on exports Changes in income tax Changes in VAT Property tax	Opposition to measures through lockouts and filing of complaints of unconstitutionality	Temporary tax on exports not approved. Reforms to income tax, VAT and property tax declared unconstitutional	1.7% (between 1986 and 1988)
Ramiro de León (1994)	Changes in income tax Equalization of rates of specific taxes (on beverages, petroleum derivatives and tobacco) with those applied by other Central American countries. Increase of VAT to 10%	Opposition to measures through filing of complaints of unconstitutionality and anti-government campaigns in the media	Increase in VAT (1996)	1.6% (between 1993 and 1996)
		Cases of negotiation by elites		
Democratic regimes with armed conflicts				
Jorge Serrano (1992)	Reduction of marginal income tax brackets and ceilings Simplification of VAT Possibility of crediting VAT against income tax	Negotiations without other actions	Adoption of reforms	0.5% (between 1991 and 1993)
Democratic regimes with Peace Accords				
Alvaro Arzú (1996-1998)	Reduction of income tax rate Simplification of VAT Elimination of exemptions Temporary taxes on sales and assets (1996 and 1998)	Negotiations without other actions	Adoption of reforms	0.4% (between 1996 and 1998)

Source: Prepared by the authors on the basis of Valdez and Palencia (1998), Urrutia (2000) and McCleary (1999) and data from the Ministry of Public Finance.

Box 1

FISCAL REFORM: ACTORS AND STYLES OF NEGOTIATION AS FACTORS OF SUCCESS

In Sweden, the United Kingdom and the United States, the legislative power and the main political parties arrived at agreements within a clear and stable framework of rules. Thanks to this framework, shifts in the correlation of forces could give rise to new policies without altering the basic rules of the game, while at the same time the institutional framework moderated the initiatives and strength of employers' associations and labour unions, particularly in Sweden and the United Kingdom. Moreover, the Executive, with its solid capacity for tax collection and the degree of autonomy enjoyed by its technocrats, ensured that reforms could be properly implemented.

In Chile, there was a process of consultation with labour sectors and the position of Chilean business leaders was taken into account in the formulation of reform proposals, but these were negotiated directly between the ruling Democratic Coalition and Renovación Nacional, the main opposition party (Boylan, 1996). At the same time, the Ministry of Finance's capacity for revenue collection and its technical and political independence did not leave any doubt as to its ability to implement proposed reforms.

In Poland, the government encouraged negotiations between workers and the State and these culminated in the signing of a social covenant covering both the question of wages –agreed through a tripartite committee of managers, government and workers– and tax policy, which was then ratified by the legislative body.

The Russian Government settled for negotiations with elites, which were a far cry from the collective bargaining that took place in Poland. In particular, the government arranged informal negotiations with (i) regional governors, giving rise to bilateral agreements on the division of revenues between the central government and local governments; (ii) managers of State-owned enterprises producing raw materials for export, which were the main sources of revenue, and (iii) entrepreneurs of the financial sector, who became the principal sources of credit for the government as well as administrators of State resources. These negotiations did not lead to lasting agreements.

Another experience with fiscal reform, which was hailed as a success at the time, was that of Indonesia, although in this case there was no democratic institutional framework to mediate between the pressures of different groups, owing to the dictatorial nature of the regime of President Suharto, who was Indonesia's Head of State for 30 years. This allowed a small group of national experts, with international advice, to establish a vast set of measures which included the introduction of a value added tax, the simplification and strengthening of income tax, and the streamlining of other laws to facilitate the tax administration but which lacked broad-based political and social support.

country, and much less the National Congress. Lastly, when such elite negotiations took place, the proposals which succeeded in gaining acceptance were those aimed at simplifying the tax system or increasing VAT and eroding direct taxation (even through the application of temporary taxes) at a time when there has been pressure to increase it. As may be seen from box 1, the involvement of the main actors and the styles of negotiation adopted have been important in international experiences.

Thus, the main features of fiscal policy in Guatemala prior to the signing of the Fiscal Covenant in 2000 were as follows: low tax income and limited allocations for social spending, deficiencies in the management of this expenditure (lack of technical instruments for measuring the quality of expenditure), and a high concentration of expenditure in the central region of the country.[3] This helps to explain why Guatemala is lagging furthest behind the rest of Latin America in terms of social indicators.

[3] For a more detailed description, see SNU (2001, pp. 3-36 and 125-178).

II

Negotiation of the Fiscal Covenant in Guatemala

1. Factors behind the emergence of the Fiscal Covenant

After more than 30 years of internal armed conflict and a long-drawn-out negotiation process, Peace Accords were signed in Guatemala in 1996. The end of the war, together with the commitments contained in those Accords, raised the expectations of citizens and of the government itself, by establishing a political covenant providing for the minimum basic understandings required for the construction of a new country. The Agreement on Social and Economic Aspects and the Agrarian Situation (ASESA), which was one of the most important of the set of Peace Accords, stated that by the year 2000 the tax burden should be at least 50% higher than in 1995 in order to provide financing for the programmes and projects designed to consolidate the peace process.

The agreements signed provided for a 50% increase in public spending on education and health (as a proportion of GDP) between 1996 and 2000, as well as other targets for increased expenditure on housing and justice, together with a moderate reduction in military spending. The Peace Accords also stated that the United Nations would be responsible for monitoring the fulfilment of these goals.

By the end of the 1990s, tax collection figures showed that the target of a tax burden of 12% of GDP in 2000 (compared with approximately 8% of GDP in the mid-1990s) was not going to be met.[4] Recognizing this fact, the Guatemalan Government advocated modification of the timetable for reaching the targets established in the Peace Accords, postponing until 2002 the date for achieving the tax target. As part of the negotiations to secure agreement on this modification, the government pledged to push forward various tax laws, which included the establishment of an income-tax-deductible tax on sales and assets, known as the tax on commercial and agricultural establishments (IEMA); the reduction of the extent to which payments of VAT could be credited against income tax; redrafting of the property tax; and measures to improve tax collection, such as the hiring of auditing companies to check foreign trade transactions.

What subsequently proved to be most important, however, was the government's additional commitment to take steps towards the signing of a fiscal covenant to promote concerted tax reform, create a new tax culture and strengthen the capacity for managing fiscal policy.[5] The idea of a fiscal covenant –inspired partly by the ECLAC book of the same name (ECLAC, 1998)– was above all a response to a long history of failed tax reforms promoted in confrontational situations in which, as already explained, complaints of unconstitutionality, lockouts and massive media campaigns were used to stave off the implementation of proposed tax reforms,.

The idea of promoting a fiscal covenant was based on the assumption that tax reform would only be sustainable if it was supported by consensus (in other words, if tax compliance were practically voluntary), in order to protect it against the forcible measures taken by various trade union or political entities. This called for a new institutional framework which would prevent individual social forces from exercising a power of veto and would thus be consistent with the existence of true democracy.[6]

2. The negotiation of the Fiscal Covenant: an attempt to create a new institutional framework

(a) *The Fiscal Covenant as a global agreement*

Negotiation of the Fiscal Covenant was started at the initiative of the members of the Committee to Monitor the Fulfilment of the Peace Accords. This Peace Committee was composed of representatives of the government, of the political party representing the

[4] The revision scheduled of the national accounts in Guatemala may alter these proportions of the tax burden (8%, 10% or 12%), but this does not detract from the original ASESA agreement, which established the need to increase the tax burden by 50% over the 1996 level.

[5] For a description of the relationship between the Fiscal Covenant and the Peace Accords, see Noriega, Alvarez and Chocoj (2001).

[6] Rosenthal (2005) highlights the importance of this condition in the Guatemalan context.

former insurgent forces, Guatemalan National Revolutionary Unity (URNG), eminent citizens identified as representatives of civil society, and United Nations representatives with observer status.

As a first step, the Committee appointed a commission, entitled the Preparatory Commission for the Fiscal Covenant (CPPF), to prepare –in consultation with representatives of different sectors of Guatemalan society– a proposal for the adoption of the fiscal covenant based on technical studies. This Preparatory Commission gave technical and political credibility to the process, since its members, as well as having a broad-based store of knowledge on fiscal issues, constituted a pluralistic group representing the different perspectives on the fiscal question in Guatemala, and some were closely related with the main political parties of the time.[7]

Despite the fact that the preparatory process of the Fiscal Covenant took place during an election year, an intensive series of consultations was held with different sectors (the academic world, the private sector, trade unions, the cooperative sector and political parties) from all over the country, and the media gave broad and positive coverage to the issue; solid technical support was also provided by international cooperation agencies,[8] which was extended to various academic and social organizations, thereby publicising the issue and contributing to extensive debates on it during the year. This culminated in the proposal for a Fiscal Covenant, which was presented publicly by the Preparatory Commission on 29 December 1999. This proposal had two features: (i) it took an integral approach, since it referred not only to tax reform but also to the whole area of public finances: public expenditure, tax administration, debt, deficit, public assets, transparency and decentralization; and (ii) it was oriented towards principles and commitments, with a medium- and long-term view, instead of being centred exclusively on short-term measures.

In February 2000, the Peace Committee sent out an invitation to take part in consultations on the proposal prepared by the Preparatory Commission to nearly 150 organizations and institutions of different types: trade unions and representatives, small and medium-sized enterprises, business chambers, cooperatives, churches, non-governmental organizations, peasant, indigenous and women's organizations, universities and research centres. In response, 48 proposals were received, representing 131 organizations. On the basis of these proposals, a technical team appointed by the Committee to Monitor the Fulfilment of the Peace Accords identified the main points of consensus and dissent. The Committee then carried out a campaign to reconcile positions between the organized business sector and social organizations. After a period of dialogue and negotiation, two different positions took shape with regard to the various issues.

After this campaign and the holding of the National Forum on the Fiscal Covenant, which brought together the organizations that had sent in proposals, final agreement was reached and the Fiscal Covenant was signed by more than 100 organizations, as well as by the representatives of the three State powers. On the whole, while there were lengthy negotiations on some sensitive issues, such as the progressiveness of the tax measures, the use to be made of the proceeds of privatization operations, and the constitutional reforms, most of the proposals made originally by the Preparatory Commission were respected and the same structure based on the establishment of principles and commitments for the whole set of public finance issues was maintained.

Gamboa and Tentravizi (2001, pp. 131-139) point out that the agreement finally reached on the Fiscal Covenant, which in the past had aroused a great deal of controversy, was largely due to factors such as the characteristics of the Preparatory Commission (its representativeness and high technical level), the identification of principles and commitments geared to the medium and long term instead of discussions on tax measures, and the existence of a single document as the basis for the debate. Other positive factors included the favourable framework provided by the Peace Accords, the unity displayed by the social organizations, which constituted to some degree a counterweight to CACIF, a flexible negotiation method, which took advantage of the experience gained in negotiating the Peace Accords, and a collective learning process which gave some flexibility or fluidity to the positions of the participants, facilitating convergence among them. In practice, this represented the entry of new actors into the discussion of an issue which had traditionally been the subject of

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[7] According to Gamboa and Tentravizi (2000, pp. 53-72), the membership of CPPF was fairly well-balanced, as it consisted of representatives of left-wing and moderate right-wing positions, the main economic advisors of the government party, and members of the leading opposition party.

[8] For the studies which served as the basis for the proposal of the Fiscal Covenant, see Preparatory Commission for the Fiscal Covenant (2000).

negotiations within a small group of senior government officials and private-sector representatives.

During this preparatory and negotiation stage, the two governments in power (the first from 1996-1999 and the second from 2000-2003) strongly supported the formulation and discussion of the Fiscal Covenant, albeit without playing a leading role. For its part, the business sector was in agreement with this process, partly because of its fear of the Guatemalan Republican Front (GRF). This political party had won the elections in 1999 with a populist, anti-business discourse, and entrepreneurs therefore viewed the Fiscal Covenant as potentially useful for defining a framework of rules that would provide a certain degree of stability and transparency to govern the role of the new administration and its relations with other sectors (Segovia, 2004, p.64).

This may be interpreted as the change in the correlation of forces which has favoured the negotiation of fiscal covenants in other circumstances, as shown in box 2. It should be recognized, however, that the perspective of a change of government every four years and the need for a certain stability and a shared vision of nationhood[9] may also have been an incentive to take a positive view of the efforts to agree on a fiscal covenant: a position which was already evident months before the elections in which the Guatemalan Republican Front was victorious.[10]

Box 2

CHANGE IN THE CORRELATION OF FORCES AS A PREREQUISITE FOR A NEW FISCAL COVENANT

In the developed countries, the quasi-voluntary tax system has been subject to renegotiations, giving rise to adjustments in the social covenants underlying fiscal policy which have been reflected in new or renewed fiscal covenants. Thus, without going into details about the basic institutional framework and the advantages of having a quasi-voluntary tax system, the history of those countries provides examples of what may be interpreted as new or renewed fiscal covenants, as occurred in Sweden in 1938, the United Kingdom between 1939 and 1941 and the United States in 1986 (Steinmo, 1993).

Each of these was triggered by some special event which altered the internal or external correlation of forces: (i) the victory of the social democrat party in the Swedish elections in 1936, which gave rise to a pact negotiated between management and labour – the basis for what was dubbed the “Swedish model”, which subsequently became firmly entrenched; (ii) in the case of the United Kingdom, the Second World War, which called for a special effort to mobilize resources to finance the armaments industry; and (iii) the electoral victory of Ronald Reagan, combined with the substantiated reports that the tax burden of the major corporations in the United States had gone down between 1981 and 1986.

The case of Chile, a developing country which has had a successful fiscal covenant since 1990, clearly illustrates how fiscal policy is associated with the strengthening of democracy and how a new correlation of forces contributes to such strengthening and to fiscal reform, giving rise to positive feedback between the two processes. The event which triggered this initiative was the establishment of a new correlation of internal forces, demonstrated initially by the rejection of the military dictatorship in the 1988 plebiscite and ratified in the 1989 elections with the victory of the centre-left forces (Christian Democrats, socialists and others) grouped together in the Coalition for Democracy. This, together with a growing fiscal deficit and with promises to reduce the social debt, led to the negotiation of a reform within its fledgling institutions, with a legislative power subject to restrictions imposed by the military government,[11] but with institutionally sound political parties, which were the pivot of the tax reform negotiation negotiations.

In Poland, which also adopted a new fiscal covenant, a transition was initiated in 1989 with a government supported by the Solidarity Movement, but with a legislature which, owing to the result of the 1991 elections, was fragmented and virtually paralysed.[12] With the institutional framework in a state of flux, the correlation of forces shifted in favour of industrial, rural and public-sector workers, who resorted initially to protest action –including strikes– in the face of the radical economic reforms introduced by the new government and in opposition to a tax on wages above a certain level (the *popiwek*).

[9] Palencia (2002, pp. 79-97 and p. 63). See also Valdez (2003).
[10] Although to the extent that there were “rational” expectations of the FRG victory, these were already being internalized or processed as part of the near future.

[11] At that time, the Senate included nine senators designated by the military regime, so that the votes of the Renovación Nacional party were decisive for achieving a simple majority in this body.
[12] The following account is based on Easter (2002).

The broad-based agreement on the Fiscal Covenant included the URNG political party and a number of social and labour organizations, which put forward proposals on the issue, taking advantage of the discreet and low-key support provided by international cooperation agencies. As a whole, the international community supported the negotiation process, highlighting the importance of meeting the 12% tax target set out in the Peace Accords, although the international finance institutions nevertheless expressed reservations on the grounds that the government might use the process as an excuse to renege on its agreement to increase the tax burden. Consequently, these institutions gave some technical support but kept their distance, which had a positive effect in the sense that it ensured genuine national "ownership" of the project. Other sources of cooperation helped actors from civil society –social and academic organizations– to carry out studies and make proposals, thus reducing the historical asymmetry characteristic of fiscal policy management, which in the past, had been restricted to government and corporate actors.

Although the Preparatory Commission had consulted the political parties during the preparation of its proposal, and although the electoral platforms of the parties included generic support for the idea of establishing a fiscal covenant, not all the parties supported it after its final negotiation –least of all the Partido de Avanzada Nacional (PAN) of the former government, which subsequently went over to the opposition. The political parties have always been apprehensive about the political cost associated with the taxes, and they were reluctant to accept or understand the argument that the covenant allowed this cost to be shared by all.

This attitude was influenced by the recognized precariousness of the political party system in Guatemala, characterized by fragmentation, a tendency towards caudillism, inconsistency and limited durability. Furthermore, there was a fundamental strategic flaw in the negotiation phase of the fiscal covenant, insofar as the effective participation of the newly elected Congress was not assured, although individual deputies did participate, including the Chairman of the Finance Committee of Congress.[13] This heralded what was perhaps the main weakness of the new institutional framework for putting the fiscal covenant into practice.

(b) *Failure of the negotiations on the tax component of the Fiscal Covenant*

Since the principles and commitments contained in the global agreement on the fiscal covenant were of a more general nature, it was easier to reconcile the different trade union and sectoral visions and to discuss concrete measures, above all, the approval or modification of taxes. The participants in the subsequent negotiations on the tax reform, under the auspices of the Monitoring Committee, were the social organizations that made up the Collective of Social Organizations (COS), the organized business sector, represented by the Coordinating Committee of Agricultural, Commercial, Industrial and Financial Associations of Guatemala (CACIF), and the main research centres: the National Economic Research Centre (CIEN) and the Association for Social Research and Studies (ASIES). The Monitoring Committee acted as moderator and the United Nations Mission for the Verification of Human Rights and of Compliance with the Commitments of the Comprehensive Agreement on Human Rights in Guatemala (MINUGUA) provided active technical and facilitation support.

There were, however, two problems that undermined this negotiation process. First, the Ministry of Finance played only a secondary role in the negotiations, partly because of apparent disagreements within the government, due to the reluctance of the latter to take part in the process because of the Coordinating Committee's disproportionate role and because it denied the government the legitimacy it had won through the elections. In practice, the extreme weakness of the Executive, reflected in its incapacity to coordinate positions on the issue, prevented the consolidation of the new institutional framework that was taking shape and was one of the causes of the failure of this initiative. The negotiations were more complex on this occasion, with disagreements on the relative importance that direct or indirect taxes should have and on the exemptions that ought to be eliminated,[14] giving rise to extreme

[13] Congress was represented on the Monitoring Committee, but this was not sufficient to ensure solid coordination with the legislative power as a whole.

[14] For the social sectors, the crucial issue was the increase in VAT, which caused internal divisions even afterwards. The VAT negotiations were contingent on an increase in the minimum wage, while for the private sector, the negotiation of fiscal privileges and direct taxation was the issue that aroused the strongest confrontations with the social sectors (see Palencia, 2002).

positions and setbacks that delayed the timely presentation of the agreement to Congress. Even so, it was possible to secure consensus on the Political Agreement for Financing Peace, Development and Democracy, which contained concrete measures for achieving the tax burden target of 12%.[15]

Second, the inability of the Executive to coordinate positions was compounded by the fact that the majority party in the Congress (FRG) did not welcome the new proposal that had been agreed, on the grounds that the deputies had not participated in the prior negotiation process, highlighting the fact that Congress could only play a limited role as a mediating and negotiating body at the highest political level.[16] Paradoxically, the legislative body, and in particular its president, General Ríos Montt, failed to take advantage of the opportunity to adopt a significant tax reform without major political costs, with increases in the income tax and VAT rates already approved by the private sector and the leading social organizations in the country. Thus, they passed up an opportunity to reach a genuine fiscal covenant.

(c) *The return to the former institutional framework*

(i) *The return to confrontation*. The government and the party supporting it then decided to convene new negotiations led by the Vice-President of the Republic. These were a failure and even led to a withdrawal to some previous positions, mainly on the part of the social organizations, which then rejected the increase in VAT. In that year, 2000, the Congress, with the support of most of the deputies of the government party, approved some of the reforms included in the Political Agreement, but without including the increase in VAT. This was done in a climate of growing confrontation with the private sector and without the support of the social organizations and the opposition parties in Congress.

Following the approval of the tax laws and in view of the inadequacy of the measures applied, there was still the threat that the VAT might be approved, subject to divergences between Congress and the executive power. When the private sector, the media and the social organizations started to challenge the government,[17] the government strategy was revised. The Minister of Public Finance was replaced and the government adopted two measures: it raised the VAT rate from 10% to 12%, as proposed in the previously negotiated Political Agreement, and increased the rates of the tax on assets and sales of commercial and agricultural establishments (IEMA). The prevailing climate was one of increasing polarization, and this led the social organizations and the private sector as well as the non-government parties to reject these measures out of hand.

While the signing of the fiscal covenant was a high point in the history of concerted action in Guatemala, the rise in the VAT and IEMA rates in 2001 was one of the lowest points because of the degree of confrontation that existed. This confrontation took on different forms: mass demonstrations by the social organizations, media campaigns against the Government, a lockout in the private sector[18] and citizen protest campaigns, in which citizens wore black, primarily as a rejection of the increase in VAT and alleged government corruption. There was also a sharp increase in the number of complaints of unconstitutionality filed, which had not been the case in 2000, when the Fiscal Covenant was signed, thus showing the credibility of the negotiation of the covenant. In 2001, in contrast, 41 complaints of unconstitutionality were filed (31 by the business sector, three by political parties and the remainder by civil society); in 2002 nine were filed (five by the business sector and four by civil society), and in 2003, 11 were filed (six by the business sector and five by civil society).

(ii) *The return to a (broader) form of elite negotiation*. Following the victory of the Grand

[15] In short, the agreement reached –known as the Political Agreement– included: (i) strengthening of tax administration and measures for combating tax evasion and smuggling; (ii) the review of existing deductions and exemptions; (iii) an increase in VAT from 10% to 12%; (iv) a rise in the maximum income tax rate from 25% to 31%; (v) other tax measures, including an increase in the tax on persons leaving the country, a new tax on alcoholic beverages, a new property tax law and the conversion of the temporary tax on assets into a permanent tax; (vi) an increase in minimum wages; (vii) the implementation of an economic reactivation programme; and (viii) the implementation of a priority public spending programme.

[16] At the same time that the Monitoring Committee was presenting the Political Agreement to Congress, the Ministry of Finance was presenting another proposal which excluded VAT and included a tax on financial transactions, thus adding to the complexity of the negotiation of the proposed reforms.

[17] Mainly because various cases of corruption and weak public management had come to light.

[18] In this case, the expressions of private-sector dissatisfaction with the increase in VAT were due to the sector's rejection of the management of the government in power, rather than of the tax itself.

National Alliance (GANA) in the 2003 general elections, the new government assumed a pro-business orientation. Paradoxically, the persistent complaints of unconstitutionality filed by the private sector in previous years –especially the resulting declaration of unconstitutionality of the tax on assets and sales (IEMA) –generated a loss of tax revenue for the new government which took office in 2004. During its first months in office, the new government therefore decided that it was necessary to modify the fiscal covenant in order to cope with the crisis. To this end, the Executive formed a Technical Committee on the Fiscal Covenant (CTPF),[19] which was entrusted with the task of preparing a draft tax reform.

This time, the consultation process was fairly limited. On the one hand, the close relationship between the Technical Committee and senior government officials not linked to fiscal policy meant, in view of the government's pro-business stance, that the business sector's main concerns were taken into account. On the other, the Committee's technical mandate helped to establish a belated but rapid process of consultations with other sectors, without prior consultation with the parties represented in Congress. At all events, the Technical Committee's proposal was finally presented to the National Committee on the Peace Accords (CNAP),[20] and submitted by the latter with minor amendments to the Congress of the Republic.

Various sectors argued that the consultations for preparing the proposal were not sufficient to serve as a basis for a fiscal covenant. The Congress of the Republic, however, carried out an additional consultation process, which took the form of public hearings. This mechanism of democratic participation, which had not been used in Guatemala, enabled the Congress to listen to the views of different social, academic, business and indigenous groups –something which had not been done in the country in the last 50 years– and for a brief spell this series of hearings and the fiscal debate it engendered were a breath of fresh air for democracy in Guatemala which enabled the country to go beyond confrontation or elite negotiation.

In actual fact, however, Congress, which once again had not been taken into account in the formulation of the tax reform proposals and did not have the benefit of specialized advice on tax issues, weakened even further the proposals made by the Technical Committee. This was partly due to complaints by social organizations (which had not been included in a broad-based consultation process), whose positions reflected urban middle-class interests which coincided with the private sector's concern that income tax should not be any higher.

The reforms to the tax laws were only approved once there was understanding between the different groups in Congress. The approved initiatives were four in number: (i) changes in income tax, whereby a streamlined payment regime providing for a tax of 5% on gross income was introduced in place of the 31% rate; (ii) the creation of a special temporary tax in support of the Peace Accords (IETAAP): a tax on assets and sales, similar to the IEMA, but with lower rates and established on a temporary basis, in keeping with the position of CACIF; (iii) a tax on alcoholic beverages, which was not in force because it had been declared unconstitutional; and (iv) authorization to increase the central government debt.

Two features of this reform should be highlighted. First, it introduced only minor amendments that reflected the existence of an elite negotiation between the government and CACIF, with the legislative power playing a weak mediatory role and agreeing to measures of simplification or of a low impact, with a temporary component in terms of direct taxation, all of which was consistent with the Guatemalan private sector's traditional approach to taxation. Second, the incomplete approval of the reforms only generated half the funds that the original reform would have obtained. In fact, the reform that was finally adopted was insufficient even to make up for the income lost because of the complaints of unconstitutionality, so that the tax burden was maintained at 10.3% in 2004: equivalent to the 2003 level, but lower than in 2002 (10.6%). When fiscal policy is analysed in full, however, there are some other advances which should be recognized, including the (recent) strengthening of tax administration[21] and a greater degree of transparency

[19] Which replaced the Monitoring Committee on the Fiscal Covenant.

[20] This body replaced the Monitoring Committee on Fulfilment of the Peace Accords (CAAP).

[21] Moreover, despite the fact that the Office of the Superintendent of Tax Administration (SAT) was conceived as an autonomous and technical entity, the continuous turnover of authorities (five superintendents in eight years of existence) has made it difficult to develop long-term policies. In addition, the transparency of the entity was strongly affected in the year 2003, when the former Comptroller of Accounts (who was later prosecuted for unlawful enrichment) was appointed director of this entity.

TABLE 2

Guatemala: Tax reforms and their outcome following the Agreement on the Fiscal Covenant, 2000-2004

Government and year of reform	Government proposals	Instruments for action	Outcome	Variation in tax burden
		Cases of confrontation		
Alfonso Portillo (2000)	Increase of VAT[a] to 12% Increase in IT[b] Reduction in the extent to which VAT payments can be set off against income tax Elimination of exemptions and deductions Modification of specific taxes (on tobacco, cement, beverages)	Negotiation, except with respect to the taxes on alcoholic beverages, which were challenged through complaints of unconstitutionality	Adoption of reforms on exemptions and deductions and specific taxes Increase in income tax	0.4% (between 1999 and 2001)
Alfonso Portillo (2001)	Increase of VAT to 12% Increase of rate of IEMA[c] Increase in the rate of specific taxes (alcoholic beverages) Reduction of exemptions and deductions	Lockout Filing of complaints of unconstitutionality Media campaigns against the government. Public protests by social organizations	Adoption of all the reforms Reforms in IEMA, income tax, and other specific taxes declared unconstitutional	1.2% (between 2000 and 2002) Repeal of IEMA and other taxes represented a 1.6% variation
		Cases of elite negotiation		
Oscar Berger (2004)	Replacement of the tax on sales and assets Modifications in income tax and specific taxes (beverages) Modifications in VAT	Negotiation Public protests by social organizations regarding VAT and income tax on wages	Adoption of reform, but without modifications in VAT and income tax on wages Reduction of rate and period of application of tax on sales and assets	Estimated temporary impact, 1.0%

Source: Prepared by the authors on the basis of data from the Ministry of Public Finance.

[a]VAT: value added tax.
[b]IT: income tax.
[c]IEMA: tax on commercial and agricultural establishments.

of public expenditure. The most important and intractable problem remains unsolved, however: the insufficiency of tax revenues.

In short, the signing of the Fiscal Covenant in 2000 did not give rise to a new institutional framework permitting tax reforms to establish a solid and sustainable tax base in the country, with quasi-voluntary compliance with tax obligations. Reform processes continued to be pursued but, like those that had predominated in previous decades, they were based on confrontation or conceived as a partly cosmetic elite negotiation with little real impact.

Mention should be made, however, of two important changes which took place in the phase following the Fiscal Covenant and could facilitate future negotiations. First, notwithstanding the policy of broad-based alliances, and in spite of doing whatever had to be done to exercise its power of veto, CACIF was unable to prevent the tax reforms imposed by the government of the Guatemala Republican Front (FRG) in 2001 and 2002, and the "success" of complaints of unconstitutionality filed by CACIF prompted a new and incomplete tax reform, now put forward by a government favourable to the business sector. In other words, CACIF ceased, at least temporarily, to have the power of veto. In addition, the weaker position in which it found itself, together with the less rigid stance of some of its representatives, led it to adopt a more flexible institutional position.

Second, and partly linked to the above, it is important to recognize the incipient but ever-increasing role played by Congress in determining the country's fiscal policy, as well as the more marked participation of social organizations in the generation of proposals and in monitoring fiscal policy. This has meant that the strategy of elite negotiation of 2004 had to be expanded, albeit belatedly and only partially, to take other actors into account.

To sum up, there is room for some degree of optimism. Both the more moderate positions adopted by CACIF in the recent past and the increased participation by social organizations and Congress in forging fiscal policy point to the possibility of a new institutional and negotiating framework in the future, with Congress assuming a more central and responsible role, which could give rise to agreed tax reforms based on quasi-voluntary compliance by Guatemalan citizens with their tax obligations in the future. Whether this materializes will depend largely on the strengthening of the political parties, especially those with the capacity to shape a vision of the State for the medium and long term and the will to implement it.

III

Conclusions:

Ten keys to a successful Fiscal Covenant

The foregoing has various implications for future actions by Guatemala or other countries in terms of fiscal policy. On the one hand, there should be clear differentiation between an isolated tax reform which may well lack any solid social or political basis and a social pact on fiscal policy. Fiscal covenants normally include long-term tax reforms that mark the country and its fiscal policy for a long time to come, based as they are on agreements which have been negotiated within the framework of the democratic institutions of the country and which have broad political and social support.[22] On the other hand, once a participatory process has been firmly established for reforming and strengthening the institutional framework in which the fiscal policy aimed at guaranteeing an effective social pact) is defined, the experiences of fiscal covenants in Guatemala and other countries suggest the following recommendations:

(i) Take advantage of the opportunities provided by changes in the correlation of internal forces in order to promote a social pact on fiscal policy.

(ii) Have an organization or well-defined institutional arrangement for driving forward the process and ensure that it is technically and politically credible and represents the main sectors involved in the negotiation of the social pact on fiscal policy.

(iii) From the outset, include the political parties and legislative power in the negotiation process, bearing in mind that the sought-for institutional change seeks to democratize the definition of fiscal policy and that this is contingent on the decisive incorporation of the parties and the legislative power as fundamental components of a democratic regime.

(iv) Base the process on a holistic and long-term approach which can expand the number of issues subject to concessions –without limiting it exclusively to the question of taxation– in order to facilitate agreements. The negotiation of a fiscal covenant should not be interpreted as a process aimed at achieving a short-term tax reform, but as a starting point for a lasting reform of the State, which, based on a change in the correlation of forces, will guide public policy in the future.

(v) Define a well-defined and clear strategy of consultations that not only ensures that the different interests are taken into account but also confers legitimacy on the process and explains its potential components.

(vi) Establish a positive relationship with the media so that they will support the process.

(vii) Disseminate information and studies on the issue, thereby contributing to a collective learning process which can facilitate convergence among positions and the development of a common “language”, which will be conducive to agreements. Serious and accurate statistics are part of such a “language”.

(viii) Use flexible negotiation techniques, bearing in mind the past experience of the country in question.

(ix) Compensate for the unequal bargaining power of different sectors by giving the weaker groups more access to information and by improving their technical and bargaining capacity.

(x) Allocate sufficient time for capacity-building and negotiation in order to achieve the desired results.

(Original: Spanish)

[22] Merriam (2004) makes a very clear distinction between these two aspects in an analysis of the Fiscal Covenant in Guatemala.

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Changes in Chile's production structure, 1986-1996:

Output and industrial interdependence

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In earlier studies, the author showed that the type of development adopted by Chile differed significantly from that of the successful East Asian countries. Up to 1986, the Chilean economy had a relatively weak and technologically unsophisticated manufacturing base, and the penetration of imported inputs was mainly at the expense of the scanty domestic productive intermediation. Therefore, neither manufacturing industrialization nor industrial interdependence appeared to facilitate the type of manufactured exports that might sustain dynamic industrial development based on external markets. The present paper analyses changes in Chile's production structure from 1986 to 1996, generally extended to 2000, using methods similar to those of earlier studies. The conclusion is that, despite the outstanding growth rates over the period, the economy still appears relatively weak as a basis for a sustainable increase in economic and technological sophistication.

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I
Introduction

This study continues previous work by the author on the changes in both production structures and industrial interdependence in Chile between 1960 and 1990 (Albala-Bertrand, 1999a and 1999b). The results were then contrasted with those of some newly industrializing countries at comparable stages of development, with the aim of assessing to what extent policies based upon the Washington Consensus would produce economic structures which were generally as successful as those of countries that had applied the Japanese/Asian model.

In short, in the last few decades, two main competing market-oriented policy models for development have arisen: the Japanese/Asian model and the Washington Consensus model. Both stress the importance of macroeconomic stability, export-led development and private enterprise. They differ fundamentally, however, as regards the development roles of the market and the State, and consequently the range and types of economic policies available (Wade, 1990; Stiglitz, 1996; Chang and Grabel, 2004).

The main emphasis of the Washington Consensus model is to ensure the liberalization of trade through the removal of most if not all trade barriers and to achieve macroeconomic stability via balanced budgets and privatization and through deregulation and liberalization in order to allow price signals to operate efficiently in the economy (Williamson, 1990). The State is to be reduced to a minimal and subsidiary role. Economic policies, therefore, are to be neutral and operate automatically through the market. The extreme version of this model postulates that market failures are always less costly than government intervention and failure, so government is irrelevant in most, if not all, cases (Krueger, 1990).

The Japanese/Asian Model, on the other hand, while expressly recognizing the importance of macroeconomic stability and export orientation, has some misgivings about the "free market" mechanism. It considers that the State should have a fundamental and pivotal role in the direction and speed of development, especially –but not exclusively– as regards industrial policy. This means that selective (not neutral) and regulatory (not automatic) policies are essential for achieving dynamic (as opposed to static) and strategic (as opposed to blind) development. Among other functions, the government should contribute to the creation of dynamic comparative advantages via enlightened protectionism, for the benefit of potential export winners, and to the coordination of the economy as a whole.[1] Even if it were not directly involved in production activities, the State would therefore provide a fundamental input in guiding and streamlining changes in production structures.

In comparing the two policy models, in his earlier works the author chose to examine the economies in which they had been applied most successfully: Chile in the case of the Washington Consensus model, and the Taiwanese economy and the Republic of Korea for the Japanese/Asian model. It was shown that in Chile, contrary to the situation in the East Asian countries, and whatever other successes the Chilean experiment may have shown, both industrial interdependence and industrialization based on exports of manufactures were still weak and unpromising as endogenous bases capable of sustaining dynamic industrial development led by external markets (Albala-Bertrand, 1999a and 1999b). As late as 1990, at least 15 years after the beginning of this experiment in Chile, and even allowing for the differences in initial conditions, Chile's economy and production structure significantly differed from those of the Republic of Korea and the Taiwanese economy.

The present paper seeks to assess whether there was any convergence between the respective situations over the period 1986-1996, which in growth terms was the most successful ever in Chilean economic history, with annual growth rates averaging 7%. After 1986, however, there seems to have been little in the way of industrial policy in Chile, and the government generally favoured the prevailing Washington Consensus policies. This does not mean that the government did not make an important contribution to the formulation or correction of policy packages to derive greater benefit from the strategy being used,

[1] See Wade (1990); Chang (1996); Stiglitz (1996 and 1998); Stiglitz and Uy (1996); Lall (1996 and 1997); Islam and Choudhury (2000), and Chang and Grabel (2004).

nor does it mean that there was no public policy aimed at nurturing certain basic manufacturing industries.[2] It does, however, mean that those strategies were neither systematic nor all-embracing and that they did not favour the type of industrial policy associated with the successes of the Republic of Korea and the Taiwanese economy: i.e., the Japanese/Asian model. To this end, this paper therefore analyses input-output data for 1986-1996, generally updating its results to 2000.[3]

To avoid any misunderstandings, it seems desirable to clarify the type of structural change that can be analysed using the methodology described below. Changes in production structures –the central focus of this paper– may result from institutional changes or from growth differentials between sectors in a given institutional framework. Chile experienced massive institutional changes between 1975 and 1985, and from 1986 to 1996 it underwent further important changes, but in more balanced and moderate ways than in the previous 10 years. The resulting variations in the composition of gross output, as described in this paper, relate to the latter period, during which the institutional framework of the earlier period was mostly retained. The variations are therefore likely to have a considerable institutional component, resulting from both the overall strategy followed since 1975 and the policy changes adopted during the period 1986-1996.[4] Thus, the method used captures some sectoral and intersectoral changes in the Chilean economy in that period, in the framework of the prevailing institutions and policy strategies that may have affected economic variables such as growth and productivity.

II
Methodology

Chenery (1960) was the first to put forward a methodology to assess changes in the structure of gross output. This methodology was based on input-output tables and was later refined by several authors.[5] The decomposition method actually used in this paper is closer to that of Wyckoff and Sakurai (1992) and Albala-Bertrand (1999a). This method of analyzing changes in production structure capitalizes on most of the advantages of the input-output approach, while avoiding most of its limitations: that is, it reduces the importance of its usual shortcomings for forecasting (Bulmer-Thomas 1982; Ciaschini, 1988).

One advantage, fully exploited here, is that the overall structural change over a given period can be decomposed into the sources of demand which contribute to the change, both for the industrial complex as a whole and for each constituent industry. The sources of demand, however, should not be taken as explaining structural change in terms of causality but only in terms of *ex-post* concomitance. These are therefore useful empirical foundations for a structurally comprehensive policy analysis, which would exceed the scope of this paper.

In turn, the method used in evaluating structural changes in industrial interdependence –understood as structural change in internal interactions among industries at the level of intermediate goods– is based on multiplier analysis applied to backward and forward linkages. The main difference between our analysis and standard linkage analysis is that, in input-output theory, the standard analysis adopts an *ex-ante* approach to the potential for planning economic expansion (Hirschman, 1958 and 1977; Syrquin, 1992). In our analysis, however, since our purpose is to analyse effective changes in structural linkages over time, the linkages represent the actual or *ex-post* interdependence of the economy in 1986 and 1996. This also greatly reduces the restrictiveness of the assumptions required for standard analysis.[6]

Consequently, starting from the standard general input-output framework, we can arrive at some useful equations for the purpose of analysing changes in production structure as well as industrial interdependence.[7] In matrix form, for structural change

[2] See Achurra (1995); Agosin (1997); Moguillansky (1999) and Ffrench-Davis and Stalling (2001).

[3] For more details, see Albala-Bertrand (1999a and 1999b).

[4] See Albala-Bertrand (1996).

[5] See, for example, Dervis, de Melo and Robinson (1982); Kubo, de Melo and others (1986); Sakurai (1990).

[6] See also Albala-Bertrand (1999b).

[7] For a full presentation of these models see Albala-Bertrand (1999a and 1999b).

we initially use an equation for variations in gross output, as:

$$\begin{aligned}\Delta X = B_0 \hat{U}_o{}^F \Delta F + B_0 \Delta E + B_0 \Delta \hat{U}^F F_1 \\ + B_0 \Delta \hat{U}^W W_1 i + B_0 \hat{U}_0{}^W \Delta A X_1\end{aligned} \qquad [1]$$

where ΔX is the variation of gross output, B is an adapted Leontief inverse, U represents the proportion of domestic intermediates to total intermediates (superindex W) and domestic final demand to total final demand (superindex F), F is final demand, E is foreign demand and W is intermediate demand. The subindices "0" and "1" represent the initial and final years (1986 and 1996) respectively. The decomposition of the gross output growth rate can be obtained by dividing the equation [1] by X_0. Each of the five terms on the right-hand side of [1], in variation or growth terms, represents a direct and indirect contribution to total demand for the gross output of the economy, and has the following standard meanings:

- $B_0 \hat{U}_0^F \Delta F$ = contribution of final domestic demand expansion (FDE);
- $B_0 \Delta E$ = contribution of export demand expansion (EDE);
- $B_0 \Delta \hat{U}^F F_1$ = contribution of import substitution of final goods (ISF);[8]
- $B_0 \Delta \hat{U}^W W_1 i$ = contribution of import substitution of intermediate goods (ISW);
- $B_0 \hat{U}_0^W \Delta A X_1$ = contribution of changes in direct input-output coefficients (IOC).[9]

We then use the following equation for variations in the share of gross output, as:

$$\begin{aligned}\delta X = B_0 \hat{U}_o{}^F \delta F + B_0 \delta E + B_0 \Delta \hat{U}^F F_1 \\ + B_0 \Delta \hat{U}^W W_1 i + B_0 \hat{U}_0{}^W \Delta A X_1\end{aligned} \qquad [2]$$

[8] Terms 3 and 4 are positive when there has been an increase in import substitution over the period. Conversely, a decrease in import substitution means an increase in import penetration.

[9] This represents the variation in demand over the period, exclusively as a result of variations in the input-output coefficients of the system, weighted by the average of X_1. If this term is positive for a particular industry, then this means that a greater proportion of the output of that industry is used as input for the production of other industries than in the base year. That is, it represents an increase in the contribution to direct intermediation by that industry with regard to the economy. As such, it represents a version of direct backward linkages (demand) from the rest of the economy to that industry, or alternatively a version of the direct forward linkage (supply) from that industry to the rest of the economy over the period (Hirschman, 1977).

where all the terms have the same meaning as above, but δ represents the deviation from balanced growth (that which would have prevailed if all sectors had grown at the same mean growth rate as the economy). This is therefore an indication of structural change through sectoral share changes over the period. The last three terms on the right-hand side are the same as before. The meaning is analogous to that of equation [1], but refers to the absolute value of the share change (δX) and the relative share change ($\delta X/X_{t1}$), rather than absolute growth (ΔX) and the growth rate ($X^{-1}\Delta X$).

To analyse industrial interdependence, we calculate backward and forward linkages. We define the backward linkage (BL) as the direct and indirect dependence of a particular industry on all industries, as they supply intermediate inputs for its own production. Dynamic industries are expected to increase their backward linkages, becoming more specialized as they develop, either because they need a greater quantity of a more varied input mix or because they have ceased in-house production of part of those inputs. Leading industries with strong vertical integration are therefore expected to exert a pull on the economy and, if they are technologically advanced, increase the technological sophistication of the overall economy. In matrix notation, backward linkages (BL) are expressed as:

$$BL = i'C^{-1} \text{ (backward linkage, row vector)} \qquad [3]$$

where C^{-1} is a Leontief inverse. Theoretically, dynamic leading industries are expected to exhibit above-average linkages and more equal distribution than other industries.

Finally, to assess how the backward linkages change over time, we simply calculate the first difference of their values between any two given years. However, as the matrix C contains both domestic and imported intermediates, a decomposition is necessary to discriminate between the two. Thus:

$$\begin{aligned}\Delta BL = i'\Delta C^{-1} = i'(C_0^{-1}\Delta A^d C_1^{-1}) \\ + i'(C_0^{-1}\Delta A^m C_1^{-1}) \text{ } (\Delta BL \text{ decomposition})\end{aligned} \qquad [4]$$

where A is a standard matrix of input coefficients. The superindices d and m stand for "domestic" and "imported," respectively. Equation [4] is a row vector of backward linkage differences between two years, "0" and "1", decomposed into domestic and imported contributions. This can be more usefully presented in terms of growth rates (or rates of change) by dividing equation [4] by the value of BL for the initial year, as shown in table 1 below.

Analogously to backward linkages, we define forward linkages (FL) as the direct and indirect dependence that all industries have on a particular industry, because they require intermediate inputs from it for their own production. Given that there is no reason why BL and FL should be similar, we have to calculate the value of FL to obtain a more complete picture of overall intermediate transactions. The procedure for doing this is fully analogous to that for BL. Then, in matrix notation, forward linkages (FL) are expressed as follows:

$$FL = C^{*-1}i \text{ (forward linkage column vector)} \quad [5]$$

where C^{*-1} is a Leontief inverse of direct and indirect input supply (rather than demand) coefficients. Again, we expect the leading industries to exhibit more evenly distributed above-average linkages than other industries.

Lastly, the decomposition of the first difference of [5] yields the following ΔFL decomposition:

$$\Delta FL = (\Delta C^{*-1})i = (C^{*}_{0}{}^{-1}\Delta A^{*d}C_{1}{}^{*-1})i + (C^{*}_{1}{}^{-1}\Delta A^{*m}C^{*}_{1}{}^{-1})i \quad [6]$$

where A^* is a matrix of direct input-supply coefficients and the superindices d and m stand for "domestic" and "imported," respectively. This equation is a column vector of forward linkage differences between two years, "0" and "1", decomposed into domestic and imported contributions. As in the previous case, this can also be more usefully presented in terms of growth rates (or rates of change) by dividing equation [6] by the value of FL for the initial year.

III

Analysis of results

For this purpose, we used a 28-industry disaggregation, plus some relevant subgroups. The analysis focuses on the period 1986-1996, generally contrasting it with the earlier period 1977-1986 analysed previously by the same author (Albala-Bertrand, 1999a and 1999b). The latter period is used only as a general reference of trends, as in these earlier studies the results were calculated with user prices rather than basic prices, since the latter were not shown in the original 1977 input-output tables.[10] The present analysis is divided into two main parts: structural change in gross output and structural change in industrial interdependence.

1. Structural change in gross output

Table 1 below shows the change both in the share of industries or services in gross production, and the growth rates for those activities, for the period 1986-1996. We begin with the three major productive sectors: the primary or natural resources sector, the secondary or manufacturing sector (which includes construction in the table), and the tertiary (services) sector.

a) *Aggregated analysis*

In the three major sectors –primary, secondary and tertiary– the degree of structural change in gross output between 1986 and 1996 was similar to that for the previous decade, but growth rates were significantly higher. The fall in the share of the primary sector, which had halted in 1977-1986, resumed during 1986-1996, with a loss of a further 3.1 percentage points. As a result, the primary sector represented 16.3% of total gross output in 1996. In the case of the secondary sector, the significant increase in 1977-1986 was partly offset, with a fall of 2.8 percentage points, so that it made up 35.9% of gross output in 1996. The opposite appears to have happened with the tertiary sector: the significant fall in its share in 1977-1986 was reversed, with an increase of 5.9 percentage points, and it represented 47.8% of total gross output in 1996. All three sectors showed exceptionally high growth rates

[10] We used the 1986 and 1996 input-output tables. The 1996 table, which is the latest available for Chile, was published in 2001 and made available on the Internet in 2002. These tables were deflated at sectoral levels, where possible, differentiating between intermediates, value added, final output and total gross output, at constant 1986 prices. To this end, we used implicit deflators from the national accounts.

over this period, especially the tertiary sector, which appeared to have lagged well behind the other two sectors during the 1977-1986 period.

For the economy as a whole, the only demand component that seems to have contributed positively to the changes in the participation of the different sectors over 1986-1996 was a significant improvement in direct intermediation, represented by the input-output coefficients (IOC). This means that input demand for the output of all sectors, especially the secondary and tertiary sectors, made a positive contribution to both the growth rates and the shares of those sectors in the economy. All the other factors show negative contributions to shares of output, especially final demand expansion (FDE), import substitution of final goods (ISF) and import substitution of intermediate goods (ISW). Even export demand expansion –the most important positive contributor in 1977-1986– now showed a negative contribution. Domestic demand and exports, and to a lesser extent intermediation, appear to have made the greatest contributions to the high average growth rate (see table 1). Only import substitution held back the average growth rate, but in a small way. These aggregated results, however, hide the heterogeneous nature of structural change, so that we will now turn to a disaggregated analysis.

b) *Disaggregated analysis*

At this level of disaggregation, we will examine productive activities in the natural resources, manufacturing or services sectors.

i) The primary or natural resources sector (table 1, lines 1 to 4). For 1986-1996, in contrast to the previous period, the shares fell for all constituent industries, especially for the non-mining primary sector, but remained virtually unchanged for copper. All industries, especially copper, showed significant increases in the growth rates of gross output, except for the fuel industries, which showed a 61% fall. All industries, however, grew at rates lower than the average for the economy, which explains their losses in terms of shares of output. The still-significant growth rates appear to have responded especially to final demand expansion (FDE) in the non-mining primary sector and to export demand expansion (EDE) in mining. The output fall in the case of fuels seems to have been mainly caused by massive falls in import substitution, especially of intermediate goods (ISW). The high growth rates of copper and other minerals, as expected, were mostly pulled by export demand, while the contribution from intermediation was almost nil, meaning that mining in Chile may have become more of an enclave industry than before. Contrary to the previous (1977-1986) period, the non-mining primary sector had a reasonably high growth rate contribution from intermediation, which may mean that these industries were better integrated in the overall economy than before.

To sum up, the copper industry retained a share in gross output similar to that in 1986, but with a significantly higher growth rate, probably because of significant support from policy measures over the period. In 1996, its share in total output was over 6%, which was good news for both overall growth and foreign exchange generation. Second, the average growth rate in the non-mining primary sector was practically double that for the period 1977-1986. Domestic demand and exports, as well as intermediation, played an important role in this recovery. Third, intermediation improved for the non-mining primary sector and consequently for fuels, while it worsened somewhat for copper and other minerals. While agriculture and associated industries appear to have become more integrated into the overall economy, extractive industries moved somewhat in the opposite direction, or lagged behind.

In terms of gross domestic product (GDP), mining increased its share between 1996 and 2000, while the non-mining primary industry (except for fishing) fell significantly; as a result, the participation of the overall primary sector was about the same in 2000 as in 1996 (Banco Central de Chile, various years). The primary sector as a whole was therefore growing at a similar rate to that of the economy as a whole, but with some internal structural changes. GDP relates only to the final demand component of gross output, but unlike gross output it is calculated at market rather than basic prices, including transport costs, wholesale margins and net indirect taxation. Hence, the growth rate and structure of GDP may provide a general picture of the behaviour of gross output over the same period, but this will not be confirmed until updated input-output tables are made available by the Central Bank.

ii) The secondary or manufacturing sector (table 1, lines 5 to 19). During the 1977-1986 period, the manufacturing sector increased its share of total gross output, but only because of light industries, since heavy industry –the most technologically advanced part of the secondary sector– saw a decline in its share. Both fell, however, during the 1986-1996 period: light industry by 3.2 percentage points and heavy industry by 1.5 points. For light industry, the main source of

TABLE 1

Chile: Growth rates and changes in the share of gross output, by production activity and sector, between 1986 and 1996 [a]

(Basic prices in constant 1986 pesos)

Production activity and sector	Share δ = (1996-1986)							Growth rate: Δ = (1996-1986)					
	δX/X96	FDE	EDE	ISF	ISW	IOC	S86	ΔX/X86	FDE	EDE	ISF	ISW	IOC
1 Non-mining primary	-1.6	-1.6	-0.6	-0.1	-0.4	1.0	7.8	75	40	26	-2	-8	19
2 Copper	-0.1	0.1	-0.1	0.0	0.0	0.0	6.5	117	9	110	-1	0	-1
3 Fuels	-1.0	-0.1	0.0	-0.1	-0.9	0.1	1.2	-61	38	19	-21	-107	10
4 Other minerals	-0.3	0.1	-0.3	0.0	0.0	-0.1	3.9	103	20	88	-1	0	-3
5 Food	-3.3	-3.4	-0.5	-0.2	-0.3	1.0	10.5	52	25	19	-3	-4	14
6 Textiles	-0.9	-0.6	0.1	-0.3	-0.1	0.1	1.5	-13	3	17	-24	-14	6
7 Clothing	0.0	-0.3	0.1	-0.2	-0.1	0.5	1.6	127	81	19	-17	-6	50
8 Lumber/wood	-0.2	-0.1	-0.2	0.0	0.0	0.2	2.6	101	48	49	-2	-3	9
9 Paper/printing	0.2	-0.2	0.0	-0.1	0.0	0.5	1.0	167	72	32	-7	-4	76
10 Leather	1.1	0.4	0.1	0.0	0.0	0.6	0.5	648	366	76	8	-6	203
11 Rubber	-0.2	-0.2	0.0	-0.1	0.0	0.1	0.6	37	14	35	-30	-3	20
12 Chemicals	-0.1	-0.4	0.1	-0.2	-0.1	0.5	2.5	112	63	39	-12	-6	29
13 Oil refining	-0.9	-0.4	0.0	-0.2	-0.1	-0.1	2.7	47	45	28	-12	-5	-9
14 Non-metals	0.6	0.1	0.0	-0.1	-0.2	0.7	1.7	198	122	30	-6	-15	67
15 Metals	0.1	0.2	0.5	-0.6	-0.3	0.3	3.1	132	93	69	-31	-13	15
16 Machinery	-0.7	0.1	0.0	-0.8	-0.3	0.4	2.4	60	85	28	-57	-23	28
17 Transport equipment	-0.2	0.3	0.1	-0.6	-0.1	0.2	1.3	78	118	39	-88	-10	19
18 Other manufactures	-0.1	-0.3	0.0	0.0	0.1	0.2	0.7	102	20	24	7	18	34
19 Construction	1.8	1.6	0.0	0.0	0.0	0.2	6.2	187	177	5	-1	0	5
20 Public utilities	0.4	-0.3	0.0	-0.1	-0.1	0.9	2.7	157	75	39	-4	-3	51
21 Commerce, restaurants and hotels	3.4	3.3	0.3	-0.2	0.1	-0.1	12.2	183	159	26	-2	1	-2
22 Finance	0.7	0.7	0.0	0.0	0.0	0.0	1.5	217	193	27	-2	0	-1
23 Business services/real estate	2.4	-1.0	0.0	-0.2	0.0	3.5	7.5	192	98	22	-3	1	73
24 Transport	1.0	0.0	0.1	-0.1	0.0	1.0	6.9	155	83	50	-2	1	22
25 Communications	1.4	1.1	0.1	0.0	0.0	0.3	0.9	483	373	53	-3	-2	62
26 Public administration	-1.9	-1.9	0.0	0.0	0.0	0.0	4.1	20	19	0	0	0	1
27 Education/health	-1.6	-1.7	0.0	0.0	0.0	0.1	4.5	44	41	0	0	0	3
28 Other services	0.0	-0.6	0.0	0.0	0.0	0.6	1.6	124	52	7	-1	5	61
I Primary sector (1-4)	-3.1	-1.5	-1.0	-0.3	-1.2	0.9	19.4	86	25	66	-2	-10	7
Non-mining (1)	-1.6	-1.6	-0.6	-0.1	-0.4	1.0	7.8	75	40	26	-2	-8	19
Mining (2-4)	-1.5	0.1	-0.5	-0.2	-0.9	-0.1	11.6	94	16	93	-3	-11	-1
II Secondary sector (5-18)[b]	-2.8	-3.4	0.4	-3.4	-1.5	5.2	38.7	105	77	27	-14	-6	20
Light industry (5-10)	-3.2	-4.3	-0.4	-0.8	-0.5	2.9	17.8	82	43	25	-6	-5	24
Heavy industry (11-19)	-1.5	-0.8	0.8	-2.6	-0.9	2.1	14.8	99	77	39	-29	-10	22
III Tertiary sector (20-28)	5.9	-0.5	0.4	-0.6	0.1	6.4	41.9	153	106	25	-2	1	23
Total/average[c]	**0.0**	**-5.4**	**-0.3**	**-4.3**	**-2.6**	**12.5**	**100.0**	*121*	*79*	*34*	*-7*	*-4*	*19*

Source: Prepared by the author on the basis of data from Banco Central de Chile (1993 and 2001a).

[a] BP : Basic prices.
δX/X : Change in share of gross output (=ΔS) (percentage points).
ΔX/X : Gross output growth rate (%).
FDE : Final demand expansion (percentage points).
EDE : Export demand expansion (percentage points).
ISF : Import substitution of final goods (percentage points).
ISW : Import substitution of intermediate goods (percentage points).
IOC : Change in input-output coefficients (percentage points).
S86 : Share of gross output in 1986 (%).

[b] The secondary sector (manufactures) includes construction.

[c] Figures in bold type are totals; figures in italics are weighted averages.

this fall was textiles, which showed negative growth rates over the period, and the food industry, whose growth rate was well below the averages for both the secondary sector and the economy as a whole. In heavy industry, the growth rates were all very positive, although mostly below the average for the economy. The main branches which lost shares were oil refining and machinery, but also chemicals, transport equipment and other manufactures. In contrast, non-metal and metal industries saw above-average growth rates with slight increases in their share of total gross output. Construction continued its upward trend with a growth rate well above the average for the period, increasing its share by 1.8 percentage points.

The factors contributing positively to growth rates were domestic demand and exports, but also direct intermediation, especially for the clothing, paper and printing, non-metal and machinery industries. In turn, the factor with a negative contribution to growth was import substitution[11] of both final and intermediate goods, especially for the rubber, metal, machinery and transport equipment industries. There was apparently less domestic capacity to produce these goods, and therefore more import penetration. From the viewpoint of changes in output shares, the lower-than-average growth rates for most industries in this sector translated into falls in their shares over the period. All the constituent factors, except for intermediation (IOC) and, to a lesser degree, export expansion (EDE), contributed to this result. Except for metal-working industries, the contribution of export expansion to the share of the secondary sector was stagnant or negative. In simple terms, this means that the contribution of exports to growth rates, even if positive, was below the average for the whole economy. For the construction sector, there was a continuous upward trend in its share, so that it represented nearly 8% of total gross output in 1996. As expected, this increase was mostly due to domestic demand expansion, but also to direct intermediation to some extent.

In short, the first point to note is that the share of the heavy-industry sector underwent a relative, rather than absolute, decline, especially in industries such as oil refining, machinery, transport equipment and other manufacturing, although there was a slight rise in metal and non-metal industries. Second, although the declines are mostly attributable to overall import penetration, there was a considerable contribution from direct intermediation, which prevented the decline from being larger. There was also a small positive contribution from export expansion. Third, the light-industry sector, as a whole, experienced a fall in its share of total output, despite high growth rates in most segments (except for textiles). Fourth, this fall was mostly due to import penetration and to weaker-than-average domestic demand and export expansion. Fifth, there was also a significant contribution from direct intermediation. This could mean that secondary sectors were better integrated with the rest of the economy than before, but it was probably mostly due to import penetration (see below). Sixth, in relative terms, there was generalized de-industrialization in both light and heavy industry. The former had shown a positive share trend in 1977-1986, which seems to have been largely undone over the 1986-1996 period. Lastly, the construction sector maintained an upward trend as a result of increased domestic demand.

From 1986 to 1996, in GDP terms, there was a significant decline in the share of manufacturing of about 4 percentage points, with a further percentage point lost by 2000. This was because growth rates in the secondary industries were below the average for the whole economy, although they were not negative, except in the case of textiles. There are also some indications that this relative loss was not accompanied by productivity increases (Mujica, 1989; Ominami, 1991; Pizarro, Raczynski and Vial, 1996). For an economy that expects to achieve an export-led type of sustainable development, this could be worrying (Ffrench-Davis and Sáez, 1995; Albala-Bertrand, 1999a).

iii) The tertiary or services sector (table 1, lines 20 to 28). In the 1986-1996 period, in contrast to 1977-1986, most of the constituent industries of this sector increased their shares in gross output significantly. The main industries accounting for these gains include commerce, restaurants and hotels, business services and real estate, transport, and communications. This was to be expected in any economy that had undergone high GDP growth over a particular period. However, this result is attributable not so much to the expansion in demand as to the large increase in the share of direct intermediation over the period, although this positive performance was partly counterbalanced by some import penetration of final goods. There was still some ground for concern, as both public administration and education and health were well below average growth rates, with significant falls in their shares of total gross output.

[11] For the way in which the contribution of import substitution was calculated here, see note 8.

To sum up, first the service sector's share increased impressively between 1986 and 1996, reversing a large fall in the previous period. Second, most of this outstanding performance was due to direct intermediation. Third, public administration and education/health showed very weak growth rates and a significant decline in shares, which could represent grounds for concern, as both are basic to a country's efficiency, i.e., to the coordination and productivity of the economy and society.

In GDP terms, the share of the services sector grew still further between 1986 and 1996, by around 3 percentage points. Commerce grew significantly, recovering from its fall in the previous period, and the same occurred with transport and, especially, communications. This was partly the result of the considerable entry of telecommunications companies over the period (Moguillansky, 1999). Finance remained more or less constant at the relatively high levels of 1986, with average growth rates close to those of GDP. The privatization and proliferation of pension funds may have contributed to this result, but the significant inflows of short-term capital were also a factor (Uthoff, 2001). In GDP terms, both public administration and education/health systematically lagged behind the average growth of the economy, not only between 1986 and 1996, but also in 2000 (Banco Central de Chile, various years).

Despite good growth rates over the period, it seems that the economy still did not favour the most technologically sophisticated sectors. Both light and heavy industry showed growth well below the average rate for the economy, losing ground in relation to services. Of the most technologically advanced industries, as classified by Wyckoff and Sakurai (1992), only metal and non-metal industries appear to have made some gains in output shares; rubber, machinery, transport equipment and other manufacturing all appear to have lagged behind. Finance, however, registered growth rates well above the average, which is normally considered a necessary complement to technological progress.[12]

In conclusion, despite the fall in the share of the secondary sector and the relative fall in the contribution of export expansion, the most interesting development over the period was the widespread increase in direct intermediation in the economy as a whole. This means that economic activities are currently more integrated than ever before, but it may also mean that the economy is now more sensitive to partial shocks. In other words, a recessive shock in one sector may have stronger negative repercussions on the rest of the economy than in the past. Nonetheless, one should consider whether this increase in direct interdependence can be attributed to the interplay of domestic productive activities or to imported input penetration. For this reason, in the following paragraphs we will look at the issue of overall industrial interdependence in 1986-1996 and focus on direct and indirect backward and forward linkages.

2. Structural changes in industrial interdependence

The level and quality of industrial interdependence or linkages have much to do with development. Increased use of efficient inputs is associated with an increasingly complex economic system, that is, one in which production involves more cycles of intermediation or interdependence, as in the developed countries. There is also a positive correlation between linkages and final output (table 2). In some industries, apparently, an increase in intermediate linkages is followed by an increase in their final output, especially for manufactured exports and heavy or more sophisticated manufactures (Chenery and Syrquin, 1986).

Table 2 shows the rates of change (or growth rates) of backward linkages ($\Delta BL/BL$), and forward linkages ($\Delta FL/FL$) for the 1986-1996 period, decomposed into domestic (DOM) and imported (IMP) contributions, both in constant 1986 basic prices.

a) *Backward linkages (BL)*

By way of illustration, in the backward linkage section of table 2, under the heading "BL86" in the left-hand section, the value 2.1 for copper means that to produce one unit of copper (with a constant value equivalent to one peso) for final demand, a total of 2.1 units of direct and indirect intermediate-inputs are needed. The normalized value of *BL* for the same year and sector, under the heading "NBL86", shows a number smaller than one, meaning that the backward linkages of the copper industry are below the average for the economy, which is to be expected as this is a "demand enclave", i.e., it generates little demand for inputs from other sectors. That value also shows average homogeneity, as it has an approximately average coefficient of variation. In 1996, the main leading or pulling sectors were mainly food and textiles, together

[12] See also Albala-Bertrand (1999a).

TABLE 2

Chile: Growth rates of backward and forward linkages, by production activity and sector, between 1986 and 1996[a]

(Basic prices in constant 1986 pesos)

		Backward linkages							Forward linkages						
Production activity and sector		ΔBL/BL(86)	DOM	IMP	BL86	NBL96	CV96	SFD86	ΔFL/FL(86)	DOM	IMP	FL86	NFL96	CV96	SV86
1	Non-mining primary	**23**	13	9	1.9	0.95	2.5	5	**15**	6	9	2.0	0.52	3.0	8
2	Copper	**3**	-3	6	2.1	0.88	2.7	9	**-1**	-3	2	1.2	0.27	4.9	5
3	Fuels	**90**	32	58	2.1	1.62	2.2	0	**545**	-89	633	7.7	11.19	1.4	1
4	Other minerals	**5**	0	5	1.4	0.57	3.6	5	**2**	-3	5	1.4	0.33	3.5	5
5	Food	**40**	24	16	2.6	1.47	2.1	13	**28**	19	9	1.4	0.41	3.9	5
6	Textiles	**97**	36	61	2.4	1.86	2.2	1	**134**	52	83	2.4	1.27	1.9	2
7	Clothing	**-4**	-15	11	2.6	0.99	2.3	2	**80**	46	34	1.2	0.47	2.7	1
8	Lumber/wood	**48**	37	11	2.1	1.23	2.0	2	**16**	4	12	2.1	0.54	2.5	2
9	Paper/printing	**-2**	-7	5	2.1	0.83	2.5	1	**44**	20	24	2.2	0.69	1.8	1
10	Leather	**-40**	-37	-3	1.9	0.45	4.7	0	**33**	16	17	1.7	0.52	2.2	0
11	Rubber	**41**	18	23	1.8	1.02	2.4	1	**82**	23	58	2.5	1.04	1.6	1
12	Chemicals	**8**	1	6	2.2	0.95	2.9	2	**30**	6	25	4.1	1.20	1.4	3
13	Oil refining	**61**	-1	62	2.9	1.87	2.0	1	**30**	-19	49	3.3	0.95	1.7	3
14	Non-metals	**23**	5	19	2.1	1.05	2.3	0	**17**	-1	18	2.8	0.74	2.1	2
15	Metals	**0**	-11	11	2.1	0.83	3.1	2	**8**	-25	33	3.1	0.76	2.1	3
16	Machinery	**24**	6	18	1.4	0.72	3.3	2	**79**	7	72	2.7	1.09	1.4	3
17	Transport equipment	**30**	8	22	1.6	0.82	3.2	1	**60**	7	53	2.6	0.92	1.8	2
18	Other manufactures	**19**	3	16	2.2	1.04	2.1	1	**55**	33	22	2.0	0.71	1.7	1
19	Construction	**31**	16	15	2.1	1.08	1.9	8	**-3**	-12	9	1.4	0.30	3.9	5
20	Public utilities	**37**	13	24	1.9	1.06	3.0	1	**19**	-9	28	2.6	0.69	2.6	2
21	Commerce, restaurants and hotels	**19**	10	9	1.8	0.83	2.7	13	**-7**	-20	13	1.8	0.37	3.4	13
22	Finance	**23**	17	6	1.9	0.93	2.7	1	**-12**	-32	20	2.3	0.45	3.1	1
23	Business services/real estate	**15**	9	6	1.4	0.64	3.5	7	**31**	1	30	2.0	0.59	2.1	10
24	Transport	**17**	4	13	2.2	1.02	2.5	6	**14**	-23	38	2.2	0.57	2.6	7
25	Communications	**16**	17	0	1.4	0.67	3.6	1	**-11**	-27	15	2.2	0.44	3.1	1
26	Public administration	**44**	31	14	1.8	1.01	2.0	7	**1**	1	0	1.0	0.23	5.1	5
27	Education/health	**34**	25	9	1.4	0.77	2.7	7	**4**	2	1	1.0	0.24	4.9	6
28	Other services	**23**	14	9	1.7	0.85	2.5	2	**77**	70	7	1.3	0.50	2.4	2
I.	Primary sector (1-4)	**9**	2	7	1.9	1.01	2.9	19	**41**	-5	46	2.0	3.08	3.9	20
II.	Manufactures: Light (5-10)	**36**	19	17	2.5	1.14	2.4	20	**46**	23	23	1.8	0.65	3.0	12
	Heavy (11-18)	**23**	2	21	2.0	1.04	2.9	10	**41**	-3	43	3.1	0.92	1.7	16
	Construction (19)[b]	**31**	16	15	2.1	1.08	1.9	8	**-3**	-12	9	1.4	0.30	3.9	5
III.	Services (20-28)	**25**	15	10	1.7	0.87	2.8	44	**10**	-8	18	1.8	0.45	3.2	47
	Average[c]	**25**	**12**	**12**	**2.0**	**1.00**	**2.6**	**100**	**25**	**-3**	**28**	**2.0**	**1.00**	**2.9**	**100**

Source: Prepared by the author on the basis of data from Banco Central de Chile (1993 and 2001a).

[a] BP : Basic prices.
Δ : Variation.
DOM : Domestic (percentage points).
IMP : Imported (percentage points).
BL : Backward linkages (pesos).
NBL : Normalized backward linkages (pesos).
CV96 : Coefficient of variation in 1996 (pesos).
SFD : Share in domestic final demand (percentage points).
FL : Forward linkages (pesos).
NFL : Normalized forward linkages (pesos).
CV96 : Coefficient of variation in 1996 (pesos).
SV : Share in value added (percentage points).

[b] The secondary sector (manufactures) includes construction.

[c] Sum of SFD86 and SV86.

with fuels and oil refining, although the latter two started from a very low base, as their share of GDP in 1986 was small or negligible. The main lagging sectors are other minerals, leather, machinery, business services and real estate, communications, and education and health. Given the importance of imported inputs in most of the leading industries, especially oil refining, and the key role of such inputs in most other sectors, this could have negative consequences for the country's productive integration.

In 1986-1996, following a trend similar to that of the 1977-1986 period, backward linkages increased on average by a further 25%. This means that when the economy produced 100 units of final domestic output, this generated on average nearly 25 more units of backward intermediate demand in 1996 than in 1986. This was due in particular to increases in the backward linkages of construction and light industry. However, a good deal of the increase came from imported intermediation, especially in heavy industry. On the whole, imported and domestic intermediates appear to share the increase in equal terms, although, in heavy industry, this increase is led by imported, rather than domestic, materials. This was also the trend in the previous period, but it appears less intense in 1986-1996. This may have consequences for both foreign vulnerability and endogenous technological development (Albala-Bertrand, 1999b).

At a disaggregated level, we can observe that, firstly, for primary industries, it seems that the rises in backward linkages are mostly due to fuels and secondarily to non-mining primary industries. In the case of fuels, there was a significant increase in both domestic and imported intermediation, but generally it was the latter which carried most weight. Copper –in contrast with the 1977-1986 period– showed a very small increase of 3%, due to a fall in domestic intermediation by three percentage points and a rise in imported intermediation by six percentage points.

Secondly, the backward linkages of the light industrial sector, which had shown a significant fall in the 1977-1986 period, registered a sizeable increase in 1986-1996, mainly due to food and textiles. Clothing, paper and printing and leather, however, showed declines due entirely to significant falls in domestic intermediation.

Thirdly, heavy industries showed a significant average increase in backward linkages, but almost completely due to imported intermediation. The strongest positive effects came from rubber, oil refining, transport equipment and machinery, with only a minor contribution from domestic sources. Metal industries, for their part, showed zero growth, due entirely to the substitution of imported for domestic inputs by 11 percentage points. Construction showed more balanced intermediation than the other sectors.

Lastly, the tertiary sector showed an increase in backward linkages, with a more important contribution from domestic than from foreign sources, except in the case of transport.

The main point here is that although imported intermediation represented 50% of the total change, this proportion rose to nearly 90% in the most technologically sophisticated part of the economy. All the constituent industries of the heavy industrial sector were strongly affected by this imported input penetration. This may conspire against endogenous sustainability, but it should preserve the competitiveness of the industries that use more sophisticated imported inputs. The open Chilean economy, then, is moving towards greater reliance on imported inputs for its normal productive requirements. In the 1977-1986 period there was a decline in domestic backward intermediation, which was then considered as reflecting a process of generalized disintermediation (see Albala-Bertrand, 1999b), but this appears to have been reversed in most industrial activities, except heavy industry.

Quite apart from its implications for employment, the increase in imported backward linkages can only directly benefit foreign exporters and domestic importers, and therefore has little or no positive effect on endogenous productive interdependence between industries. From this point of view, the potentially positive results of an increase in the demand for inputs would have an impact both outside the economy, on foreign exporters, and on the trade of domestic importers, but they would be of little help to domestic productive manufacturing. This could be insufficient for the development of domestic manufacturing.[13]

b) *Forward linkages (FL)*

In similar fashion to what occurs with backward linkages, an economy with a growing and dynamic industrial base would be expected to have a broad, strong supply of domestic intermediate goods. This of course does not preclude firms increasing their output to satisfy both final and export demands provided that,

[13] As in the extreme case of an assembly-line manufacturing economy which only assembles parts produced abroad but purchases those parts from domestic importers belonging to other sectors.

other things being equal, they do not do so on a widespread and intensive basis at the expense of domestic input supply (Albala-Bertrand, 1999b). During the period studied, total forward linkages grew at the same rate as backward linkages, but the whole of this increase was due to growth in the domestic supply of imported inputs, which also displaced three percentage points of the existing supply of inputs of domestic origin. If we exclude the two industries (fuels and textiles) which showed the highest variation in forward linkages, the increase is more moderate, but keeps the same pattern. There was a generalized fall in forward intermediation of domestic origin, so the growth in input supply was due to an increase in the supply of imported inputs, at the expense of domestic supply. In other words, increases in value added created opportunities for suppliers of imported inputs, rather than domestic producers.

This may mean that, in practice, a fair number of domestic producers gave up the possibility of supplying the internal market with domestic products, in favour of marketing imports. This trend had already been apparent in the 1977-1986 period, when almost all the industries considered showed negative intermediation from domestic sources. In 1986-1996 that trend continued to some extent: for a good number of sectors the change in domestic intermediation was negative, while that of imported input supply was positive. Except for light industry, all other sectors showed negative contributions from domestic intermediation. The worst-affected sectors were fuels, metals, finance, transport and communications. This indicated both a consolidation of the domestic disintermediation seen in the previous period and a further departure from the type of domestic integrative process experienced in the Taiwanese economy and the Republic of Korea (Albala-Bertrand, 1999b). As with backward linkages, this represents a generalized process of domestic disintermediation.

A general conclusion for both backward and forward linkages is that this intense import penetration can have mixed consequences for the development of a growing economy. On the one hand, the economy can select the most efficient foreign sources for its input requirements and use inputs that are more technologically sophisticated, which may be beneficial. On the other hand, the economy may become more vulnerable to external fluctuations, which can lead to increased instability (Damill, Fanelli and Frenkel, 1996; Chang and Grabel, 2004). No less importantly, the economy may lose an important degree of efficiency by not exploiting the domestic synchronization of the necessary inputs and their specifications, thus stifling the potential for domestic technological development. The avoidance of this anomaly, associated with deliberate input policies, proved to be one of the main engines of efficient coordination between the needs of industry and supply from domestic producers in the Taiwanese and Korean economies, which also helped to improve domestic technological sophistication.[14] This factor appears to have been further eroded in Chile over the 1986-1996 period, and also, in general, up to 2000 (Banco Central de Chile, various years), which may have had negative consequences for sustained, technologically advanced growth. In other words, in order for Chile to take full advantage of its potential for efficiency and technological development –as the Taiwanese economy and the Republic of Korea did– access to varied foreign input sources must be balanced with the nurturing of sources of domestic inputs. Given that there are costs and benefits involved in liberalization and regulation strategies, policymakers need to strike a delicate balance between the two in order to ensure, or at least not suffocate, the endogenous sustainability of increased domestic technological sophistication and the efficiency associated with inter-industry coordination.

[14] See Kubo, de Melo and others (1986); Wyckoff and Sakurai (1992); Chang (1996); Stiglitz (1996); Albala-Bertrand (1999b); Islam and Choudhury (2000); Chang and Grabel (2004).

IV

Conclusions

Up to 1986, Chile appeared to have departed from, or at least not moved towards, the kind of successful industrial structure that the Taiwanese economy and the Republic of Korea had achieved some 15 to 20 years after the beginning of their rapid drive to development (Albala-Bertrand, 1999a and 1999b). Almost 20 years after its fully-fledged economic liberalization began, the structure of the Chilean economy does not appear to have closed the gap with the two Asian countries. If anything, it seems to have fallen further behind, especially in the area of endogenous technological sophistication. This may have long-term consequences in terms of technological development, sustainable development and the overall stability of the economy.

ECLAC data show that, as late as 1996, the share of manufacturing in GDP was around 20% and that of heavy industry around 2%. Likewise, the share of exports in GDP was around 25%, but that of manufacturing exports was only 3%, while the share of heavy manufacturing in GDP remained negligible. This pattern continued until 2000 and does not seem to have changed significantly to date (ECLAC, various years). Given that the Chilean economy slowed significantly or was in recession after 1996, with an average growth rate around half of that achieved in the previous 10 years, it is unlikely that domestic intermediation has increased or that sophisticated manufacturing has taken hold. Furthermore, these insufficiencies can have negative impacts on income distribution, anti-poverty measures, and overall well-being, or at least delay improvements in those areas.[15]

Therefore, other successes notwithstanding, the economic development model adopted by Chile still does not appear to favour endogenous interdependence, especially of the type led by technologically sophisticated sectors. Neither does it appear to be leading towards the type of exports that can sustain and promote dynamic export-oriented industrial development. In other words, the economy still appears to be relatively weak as a basis for a sustainable increase in economic and technological sophistication.

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[15] The figures on poverty and income distribution for the Taiwanese economyand the Republic of Korea are among the best in the world (Islam and Choudhury, 2000; Sundrum, 1990). In Chile, almost two decades of structural change left unprecedented levels of both poverty and inequalities (Albala-Bertrand, 1996). Although poverty has been reduced since the return to democracy in 1990, income distribution has continued to worsen; the inequalities inherited from the dictatorship have remained. Chile is now the country with the ninth worst income distribution in the world (UNDP 2004; MIDEPLAN, 2000; Pizarro, Raczynski and Vial, 1996).

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Preliminary Overview of the Economies of Latin America and the Caribbean, *2005*, LC/G.2292-P/I. United Nations publication, Sales No. E.04.II.G.188, ECLAC, Santiago, Chile, December 2005, 182 pages.

The Latin American and Caribbean economy grew for the third consecutive year in 2005. GDP expanded by an estimated 4.3%, which translates into a per capita GDP growth rate of close to 3%. This expansionary phase of the business cycle is expected to continue in 2006, although the growth rate is likely to be slightly lower (4.1%). If these projections prove correct, the average growth rate for 2003-2006 will be a little over 4%, while the cumulative increase in per capita GDP will be close to 11%. From a historical standpoint, this growth phase is an extremely positive development for Latin America and the Caribbean, but the fact remains that most of the economies in the region are growing more slowly than those in other regions of the world, and in some cases even more slowly than the developed economies.

Although growth has been seen across the board, the South American economies and, to a lesser extent, those of the Caribbean have witnessed a faster increase in activity than Central America and Mexico. One of the main reasons for these inter-subregional differences is the trend in the terms of trade, which improved by an average of 4.8% for the region as a whole in 2005. This trend has been extremely favourable for the South American countries and, to a lesser extent, Mexico, but the Central American countries, which are net oil importers and compete with China in the United States textile market, have seen not only a deterioration in their terms of trade but also a reduction in export growth in real terms.

Exports, boosted by the favourable international situation, continue to be one of the most rapidly growing components of demand, with the region's export volumes expanding at about 8% on average. With some exceptions, the higher growth rates tend to be located in South America and the lower ones in Mexico and Central America.

The combination of this increase in export volume and the impact of remittances, together with the improvement in the terms of trade, have led to what could be regarded as the most outstanding feature of this period of economic growth, i.e., the fact that it has been coupled with a mounting surplus on the balance-of-payments current account. This is an unprecedented occurrence in the economic history of the region. For 2005, the region is expected to post a current account surplus equivalent to 1.3% of GDP, which is even higher than the surpluses of the two preceding years (0.9% in 2004 and 0.5% in 2003).

Another engine of growth has been investment, with gross fixed capital formation rising by 10% in the region as a whole (here again, with significant differences among the subregions). In virtually the entire region, however, investment, measured as a percentage of GDP, is still very low and is not climbing fast enough to fuel a sufficiently high growth rate to resolve the problems relating to employment and the population's general well-being that persist in the region. Nonetheless, the improvement in economic conditions has begun to carry over into the labour market. The upturn in employment made possible by the economies' expansion, in combination with the slower growth of the labour supply (owing, in part, to the fact that fewer young people are joining the workforce) has pushed the unemployment rate down from 10.3% to 9.3%. The fact that this reduction has been accompanied by an increase in the formal sector's share of total employment underscores the important role played by high and sustained economic growth in the improvement of labour and social conditions.

The governments of the region are taking advantage of this favourable situation to improve their public-sector accounts. The fact that the increase in fiscal revenues generated by brisker economic activity and the high prices of some of the region's commodity exports is not being accompanied by a matching trend in expenditure is quite unusual for region. Instead, the region is using its mounting primary surpluses (1.1% of GDP as a simple average for 2005, compared to 0.7% in 2004) to pay down the public debt more rapidly than other emerging economies, and even the developed countries (whose levels of indebtedness are actually on the rise).

The continuing appreciation of almost all the Latin American and Caribbean countries' currencies has begun to generate some concern. Although there is some scope for exchange-rate and monetary policy to influence the real exchange rate in the short term, both theoretical considerations and historical experience point to the difficulty of using this mechanism as an instrument for fostering long-term competitiveness. This can only be achieved by boosting productivity through higher levels of investment in physical and human capital and by raising the quality of products and their degree of processing, together with the ongoing incorporation of innovations.

The region is expected to grow at a similar pace in 2006, although the actual rate may be slightly lower. The projected growth rate of 4.1% would translate into per capita GDP growth of around 2.5%. The inflation rate is expected to remain stable at about 6%, as in 2005.

Economic Survey of Latin America and the Caribbean, 2004-2005, LC/G.2279-P/I. United Nations publication, Sales No. E.05.II.G.2, ECLAC, Santiago, Chile, December 2005, 358 pages.

This edition of the *Economic Survey of Latin America and the Caribbean* is the fifty-seventh in this series. It is divided into two parts. The first analyses the main features of the regional economy, while the second examines the situation in the individual countries of Latin America and the Caribbean. The full statistical appendix is published in electronic format for ease of data processing.

Part one deals with the performance of the region's economy as a whole and begins with an introductory section that analyses recent changes in some aspects of the region's trade linkages and financial position. This section then goes on to discuss changes in the macroeconomic policies being pursued by many countries, together with their implications for the region's growth. The following chapters are devoted to the international situation and the external sector, macroeconomic (fiscal, exchange-rate and monetary) policy, and the region's performance (level of economic activity, inflation, employment and wages). It includes text boxes on such issues as the restructuring of Argentina's external debt and the progress being made under the Heavily Indebted Poor Countries (HIPC) Initiative. These analyses highlight important factors in the current economic environment and, more specifically, in the effort to reduce the region's vulnerability.

The main link between economic development and social development is the labour market. This market has performed poorly in recent years, and a special chapter on the topic has therefore been included in this edition of the *Economic Survey*. In this chapter, after a brief review of recent trends in the region's labour markets, the discussion moves on to labour-market and employment policy options for improving job creation and employment conditions.

Part two provides overviews of macroeconomic policies and trends in the Latin American and Caribbean countries in 2004 and the first half of 2005. These country reports include tables on the main economic indicators.

The print version of the statistical appendix contains 25 regional tables, while the statistical appendix included in the attached CD-ROM includes over 400 tables which provide ready access to information for recent years and facilitate the creation of electronic spreadsheets. The CD-ROM also contains the electronic version of the text and figures presented in the *Economic Survey.*

Other publications

El medio ambiente y la maquila en México: un problema ineludible, Libro de la CEPAL, No. 83, LC/MEX/G.9, United Nations publication, Sales No. S.05.II.G.114, ECLAC, Santiago, Chile, September 2005, 317 pages.

The central focus of the studies contained in this book, though not the only subject considered, is the maquila industry and its influence on the environment along Mexico's northern border. This assembly-plant industry has experienced extraordinary growth and constitutes the most direct integration link between the economies of Mexico and the United States. The environmental impact of its activities has been discussed considerably, though studied very little until now, in part due to the lack of suitable systematized information. Throughout the different chapters comprising this volume, the topic is addressed from distinct points of view that are sometimes contradictory, yet reveal the current reality of this matter.

The first chapter deals with the unsustainable use of natural resources in northern Mexico's semi-arid border zone and the pressure that the maquila industry exerts on its fragile ecological surroundings. Factors that make the sector's development unviable under present conditions include a significant water shortage and mismanagement, and poor infrastructure to support sizeable population growth. The second chapter, pertaining to the automotive and electronics maquilas of the northern border, expresses an optimistic vision concerning the interaction between these maquila sectors and the environment, affirming that the companies are improving their environmental protection as they progress from the days of slow technological development to a generation of cutting-edge technology. The third chapter provides an analysis of the electronics maquila industry on the northern border. Although companies are noted to have made some headway in environmental protection, the environmental strategy applied by electronics maquilas is lagging far behind the industry standards at the international level. Consequently, the sector is losing out an opportunity to take advantage of market niches with greater value added, while also failing to adequately protect the environment and workers' health. The fourth chapter develops a new theoretical framework in which economic growth and hazardous waste production are concurrently related. According to this view, technological progress can worsen the maquila's environmental conditions unless accompanied by strict regulation. In the fifth chapter, the frame of reference formulated indicates that excessive environmental regulation can hinder companies' adoption of measures to protect the environment. The only option for a company wishing to attain optimal environmental performance is to develop its technological innovation capabilities. Having an adequate perception of the environmental risk will help companies to achieve this goal. In the final chapter, pollution generated by the entire maquila industry is estimated and attributed more to expansion in the scale of production than to a concentration in highly polluting sectors. Evidence is preserved on anti-pollution technological innovations (many of which are endorsed by ISO 14000 and "Clean Industry" certifications) and on the declining ratio of energy and fuel consumption to value added in the maquila industry.

Política fiscal y medio ambiente. Bases para una agenda común, Libro de la CEPAL, No. 85, LC/G.2274-P, United Nations publication, Sales No. S.05.II.G.140, ECLAC, Santiago, Chile, December 2005, 266 pages.

The first part of the book lays the conceptual foundations for analysing the different spheres of interaction between fiscal and environmental policy in Latin America and the Caribbean. Chapter I reviews the application of economic instruments as part of environmental management and the variety of ways in which fiscal reforms with environmental components have been advocated at the international level. The first chapter also analyses the practical challenges associated with implementing such instruments in the region, given the fact that most countries lack an operational legal and institutional basis to enable the environmental and fiscal authorities to formulate joint proposals in terms of policy and economic instruments for the purposes of national environmental management.

Chapter II offers a theoretical perspective on policy coordination problems and the conceptualization of "coordination problems" in the sphere of public policies. The chapter goes on to examine the reasons why coordination within State institutions may be suboptimal and refers to the need for the various levels and sectors of government to improve the integration, coherence and coordination of all policies aimed at achieving national sustainable development targets.

The third chapter analyses the experience of industrialized countries that are members of the Organisation for Economic

Co-operation and Development (OECD) in terms of their efforts to promote environmental taxes and fiscal reforms oriented towards environmental management goals. In this context, fiscal instruments are seen as the ideal means of sending the right signals to the market, reducing or eliminating distortions (such as inappropriate energy and transport tariffs) and internalizing externalities while increasing the effectiveness of existing measures.

From the perspective of the International Monetary Fund (IMF), chapter IV looks at whether developing countries could make greater use of fiscal instruments for environmental purposes. Of course, the question is not an easy one to answer. Ideal policy combinations would include fiscal and other elements, in addition to preventing existing fiscal policies (particularly subsidies and tax benefits) from aggravating existing environmental management problems.

The three chapters that make up the second half of the book present national cases that illustrate the variety of crossover fiscal and environmental issues in the political agenda of Latin American countries. Chapter V is a case study of Brazil and its experience with the use of the sales tax on merchandise and services (ICMS) as a fiscal instrument for environmental management in states and municipalities. Under this system, a percentage of the tax receipts is allocated to the area on the basis of the volume, distribution and quality of local public spending on the environment. The chapter also considers factors that help or hinder the implementation of the tax, ways of improving and broadening its use, and the prospects of the Brazilian tax system developing to enable increased use of instruments to support environmental management objectives at the level of federal, state and municipal governments.

The case study presented in chapter VI concerns Costa Rica and opens with a summary of the country's experience of using fiscal instruments as a way of resolving environmental problems. This is followed by a detailed analysis of the design and implementation of the Environmental Services Payment (PSA) system and its development and outlook for the future. The PSA system involves transfers to compensate the opportunity cost of conservation of the forests that provide hydrological services (plus other environmental benefits and services). Despite the progress that Costa Rica has made in implementing its 'green agenda' (conservation of forests and national parks and promotion of reforestation), it now faces the challenge of making similar advances in the 'brown agenda', seeking integral solutions to pollution problems in the greater metropolitan area. This is where fiscal instruments have a crucial role to play in environmental management, including the recently published decree announcing an environmental tax on dumping, a financial instrument for controlling and preventing water pollution in Costa Rica.

Lastly, Chapter VII deals with Colombia, including an assessment of the application between 1997 and 2003 of tax benefits for environmental management and investment, especially in terms of VAT exemptions and income tax deductions available under the country's current tax rules. This is followed by an analysis of the tax principles and concepts that form the basis for the current rules, the regulations governing access to the benefits and the results of applying these incentives in terms of their contribution to achieving the sectoral policy objectives of improving the quality of the environment. The analysis identifies the coordination problems between fiscal and environmental policy in the design of this incentive policy, and proposals are then presented on how its effectiveness could be improved.

Aprender de la experiencia. El capital social en la superación de la pobreza, Libro de la CEPAL, No. 86, LC/G.2275-P, United Nations publication, Sales No. S.05.II.G.93, ECLAC, Santiago, Chile, September 2005, 228 pages.

This new publication of the Economic Commission for Latin America and the Caribbean (ECLAC) contains a selection of studies on social capital and poverty reduction programmes. These analyses were prepared as a contribution to discussions at the International Seminar on Social Capital and Programmes to Overcome Poverty: Guidelines for Action, held in Santiago, Chile, on 11 and 12 November 2003. The event was sponsored by the Government of Italy as part of the Project on Social Capital and Poverty Reduction: Potential Uses of New Social Policy Instruments.

The work is presented in three sections. The first introduces two studies which provide a general conceptual overview of social capital and its relationship with poverty reduction programmes. This is followed by an analysis of social capital approaches and their interconnections from the viewpoint of life strategies and issues of clientelism.

The second section describes country studies conducted in Argentina, Brazil, Chile and Mexico. The Mexican study focuses on the Opportunities Programme, which is a pillar of the country's social policy. The study on Chile analyses the Chile Solidario (Chile Solidarity) and Chile Barrio (Chile Neighbourhood) programmes, public-safety programmes in the shanty towns of La Legua and La Victoria, and programmes executed by the National Institute for Agricultural Development (INDAP) to provide support for poor rural producers. In the case of Argentina, the focus is on six social programmes launched in the 1990s: the Participatory Social Investment Fund (FOPAR), the Care Programme for Vulnerable Groups (PAGV), the Neighbourhood Improvement Programme (PROMEBA), the Agricultural Social Plan (PSA), the emergency employment plan known as "Plan Trabajar", and the Plan for Unemployed Men and Women Heads of Household (PJHD). Lastly, the Brazilian study analyses the participatory budget of Porto Alegre and the applicability of the concept of social capital.

The final section summarizes the experiences reviewed in the country studies. An analytical matrix is used to systematize a number of proposals for improving the design of poverty reduction programmes at the local level from a social capital perspective.

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Revista de la CEPAL / *CEPAL Review*

La Revista se inició en 1976 como parte del Programa de Publicaciones de la Comisión Económica para América Latina y el Caribe, con el propósito de contribuir al examen de los problemas del desarrollo socioeconómico de la región. Las opiniones expresadas en los artículos firmados, incluidas las colaboraciones de los funcionarios de la Secretaría, son las de los autores y, por lo tanto, no reflejan necesariamente los puntos de vista de la Organización.

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REVISTA DE CIENCIAS SOCIALES DE LA UNIVERSIDAD AUTÓNOMA DE NUEVO LEÓN

Directora: Esthela Gutiérrez Garza

Año VII *Número 18* *mayo-agosto de 2005*

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Directora: Esthela Gutiérrez Garza
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Año VII *Número 19* *septiembre-diciembre de 2005*

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