

# Washington Contentious

*Economic Policies  
for Social Equity  
in Latin America*

Nancy Birdsall and Augusto de la Torre  
with Rachel Menezes



Findings of the Commission on Economic Reform in Unequal  
Latin American Societies sponsored by the Carnegie Endowment  
for International Peace and the Inter-American Dialogue



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*Washington Contentious: Economic Policies for Social Equity in Latin America*, Nancy Birdsall and Augusto de la Torre, (Carnegie Endowment for International Peace and Inter-American Dialogue, 2001).

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1779 Massachusetts Avenue, NW, Washington, DC 20036  
202-483-7600  
**[www.ceip.org](http://www.ceip.org)**

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# Foreword

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At the end of the 1990s the future of Latin America seemed grim in the face of four devastating problems—slow and unsteady economic growth, persistent poverty, social injustice, and personal insecurity. For 10 years Latin America had pursued—with considerable vigor—the 10 economic policies that make up the Washington Consensus, the growth formula promoted by the U.S. Treasury and the international financial institutions. But performance fell far short of expectations, and a new approach was needed.

We created a task force to identify more effective economic and social policies for Latin America. The independence of our two institutions—the Carnegie Endowment for International Peace and the Inter-American Dialogue—allows us to raise issues that are difficult to raise in polite, official discourse: capital controls as a solution to currency crises, the need for more taxation in most of Latin America, the myth of race-blind societies in the region, corruption in labor unions. We can also talk about the mistakes of specific countries and their leaders, and we do not have to hedge our recommendations.

The task force operated under the outstanding leadership of co-chairs Nancy Birdsall of the Carnegie Endowment and Augusto de la Torre, Ecuador's former central bank governor and member of the Carnegie Economic Reform Network. After considerable debate the task force settled on a theme: now that nearly every Latin American government has voiced a commitment to the goals of poverty reduction and greater equity, what steps do they have to take to turn that commitment into action?

The final report provides a rich new agenda of economic policies directed at reducing poverty and increasing equity—without sacrificing growth. It deserves wide readership and should exert substantial influence on policy. We are grateful to Nancy and Augusto for their perseverance, intellectual rigor, imagi-

nation, and sound judgment. We also want to thank the members of the commission for their valuable contributions and Rachel Menezes for her many intellectual and logistical contributions to this report.

Jessica T. Mathews  
President  
Carnegie Endowment for  
International Peace

Peter Hakim  
President  
Inter-American Dialogue

# Preface

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We are lucky Peter Hakim pursued us to undertake this report—because putting it together has been far more thought-provoking and rewarding than we ever could have expected.

It's been more thought-provoking on two scores. Once we had our theme—improving equity without giving up growth—we thought we knew, more or less, what we needed to say. We failed to anticipate how difficult it would be to go from good analysis to practical and specific policy proposals: on land reform, on taxes, on the barriers that indigenous groups and blacks face, on competition policy, on a countercyclical social safety net. On some of these proposals, and on others, readers may justifiably feel we have been too modest, or too ambitious, or insufficiently pragmatic.

Nor did we know how hard it would be to say what we wanted to say in plain language and in reasonably concise and convincing form. We are trained economists, happily ensconced in the comfortable shorthand that our in-house jargon affords. We hope readers will forgive our lapses—sometimes no doubt into too much of the economics, and other times too little.

The exercise has also been far more rewarding than expected. First, we have had the satisfaction of working with and learning from each other. On every topic one of us (luckily) knew more than the other. But the other knew more than the average development wonk and was a willing, engaged, and intelligent critic. Second, we were lucky to benefit from the insights and expertise of commission members and of many other friends and colleagues.

We thank commission members Javed Burki, Colin Bradford, Eliana Cardoso, Roberto Daniño, Christian Gómez, Ricardo Hausmann, Nora Lustig, Moisés Naím, and Guillermo Perry for their insightful comments during our meetings. We are particularly grateful to commission members Carol Graham and Kurt Weyland for discussion of the politics of pro-poor economic policies, and to John Williamson for his help with our discussion of the original Washington Consensus.

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Conversations with many other colleagues affected not only the research we sought out but the topics themselves—and of course the policy proposals. We thank Shanta Devarajan and François Bourguignon for their early help on expenditure issues; Gustavo Marquez and Carmen Pagés for their guidance on labor issues; Luis Guasch for his suggestions on public service issues. We received contributions from Ruthanne Deutsch (on ethnic and racial minorities), Jeffrey Puryear (on education), Hans Binswanger (on land reform), and Vito Tanzi (on taxes and expenditures). And for help on these and other issues we thank Patricia Arregui, Meg Berger, Florencia Castro Leal, Claudio Cortellese, Tamara Ortega Goodspeed, Jim Hanna, Norman Hicks, Tor Jansson, Jerome Levinson, Eduardo Lora, Truman Packard, Anita Schwarz, Dani Schydlovsky, Donald Terry, Alberto Valdes, and José Valdez.

Halfway into the exercise we presented a draft to the members of the Inter-American Dialogue's Sol Linowitz Forum 2000. Their enthusiasm sustained us and their many suggestions led to substantial revisions. We would particularly like to thank Robert Anderson, Roberto Baquerizo, Carmen Barroso, Peter Bell, Sergio Bitar, Meriel Bradford, Margaret Catley-Carlson, José María Dagnino Pastore, Whitney Debevoise, Enrique Garcia, Osvaldo Hurtado, Michael Gavin, Xabier Gorostiaga, Juan Manuel Santos, and Elena Viyella de Paliza. Several members of the Carnegie Economic Reform Network provided important comments; in particular we want to thank Alejandro Foxley. The comments of the members of the Women's Leadership Network reminded us of the continuing controversy about the original Washington Consensus; we thank Lourdes Flores Nano and Ruth de Krivoy, as well as Joan Caivano and Mayra Buvinic for organizing our presentation to that group.

Lucy Conger edited our original draft. Bruce Ross-Larson and his team at Communications Development edited the final manuscript and designed and produced the report. At the Carnegie Endowment junior fellows Brian Deese and Robert Johnson helped with research; Trish Reynolds and Sherry Pettie guided the manuscript through its final publication; Staci Warden was stalwart in providing comments and psychological support.

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We are especially grateful to David de Ferranti, vice president, Latin America and Caribbean Region, World Bank, for his enthusiastic backing of Augusto’s involvement in this project.

There are two people without whom we would not have begun, and having begun, would not have finished. Peter Hakim, president of the Inter-American Dialogue, not only got us started but kept us to a high standard of accessibility and realism as we proceeded. And Rachel Menezes, program associate, Inter-American Dialogue, was unstinting in her willingness to do anything and everything: research, drafting, finding experts, arranging meetings, editing, keeping the two of us on track. She did this with enthusiasm and great skill, bringing her talent, professionalism, and good instincts as a journalist to every task—small and large.

Finally, we are grateful to the Ford Foundation for its contribution to Carnegie’s work on inequality and for its general support of the Dialogue.

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# **Washington Contentious**





## **Part 1**

# **Moving Beyond the Washington Consensus**



*A new and overriding objective has emerged: to reduce poverty and improve equity without sacrificing growth.*

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**In the past 15 years the dominant direction** of economic policies worldwide has been to reduce barriers to foreign trade and investment, sell state-owned companies to the private sector, and tighten fiscal and monetary practices. In a seminal article in 1990 economist John Williamson labeled this policy package the “Washington Consensus” because of its backing by the U.S. Treasury and the Washington-based international institutions (the International Monetary Fund, the World Bank, and the Inter-American Development Bank). The consensus detailed by Williamson comprised 10 economic reform policies. The policies emphasized stabilization of prices to return developing countries to a path of sustainable growth and structural adjustment measures to make economies more efficient and competitive.

In the 1990s the technical and political leadership in Latin America firmly embraced the Washington Consensus economic reform package—for some obvious reasons. Latin America’s state-directed economies had slumped badly in the 1980s, and the Communist economies had failed outright. The policy changes in the region were strongly supported by the international institutions, and were reinforced with policy-based lending and conditionality. And after the disastrous 1980s leaders hoped the changes would attract private capital back to the region.

Williamson later noted that the consensus views he had compiled were oriented to efficiency, not equity (box 1). “I deliberately excluded from the list anything which was primarily redistributive, as opposed to having equitable consequences as a byproduct of seeking efficiency objectives, because I felt the Washington of the 1980s to be a city that was essentially contemptuous of equity concerns.”

But times have changed. Policy makers in Washington and Latin America no longer hold equity in contempt. A new and overriding objective has emerged: to reduce poverty and improve equity without sacrificing growth. In the rhetoric at least, poverty reduction and equity now dominate.

This report proposes “10 + 1” new policy tools to advance that new objective in Latin America. These tools, we hope, will provide

## *The 10 items in the original Washington Consensus said more about equity and poverty reduction than most commentators realize . . .*

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### **Box 1 On Equity in the Original Washington Consensus**

The 10 items in the original Washington Consensus said more about equity and poverty reduction than most commentators realize—perhaps because those with influence at the time, in Washington and in Latin America, brought their prior beliefs to what they read and remembered.

**1. Fiscal discipline** was explained as an instrument for efficiency and growth. As it turns out, it is central to equity, too. The consensus formulation made no mention of a particularly important rationale for fiscal discipline: the need to be ready to finance (countercyclical) social programs when times are bad, both as a macroeconomic corrective and to provide unemployment and other insurance to the vulnerable.

**2. Public expenditure priorities.** The consensus said public money should go to activities “with high economic returns and the potential to improve income distribution.” The emphasis was on shifting away from indiscriminate subsidies and toward education and health. Critics on the left have forgotten or overlooked this item—perhaps because it is so notably inconsistent with the image of the consensus as “neoliberal.”

**3. Tax reform.** The consensus formulation said the “tax base should be broad and marginal tax rates should be moderate.” In retrospect the objective ignored the issue of how to make tax regimes more progressive, especially how to minimize widespread evasion by the rich. The consensus did include the suggestion to tax flight capital—which we also include, as a good way to make systems visibly more fair and to increase revenue.

**4. Interest rates.** The consensus called for an end to directed credit (public programs to provide cheap loans, usually by arbitrary criteria) and controls on interest rates paid to depositors. The idea was to liberalize financial markets. Compared with a decade ago, the consensus has shifted—to gradual and cautious liberalization until regulatory and supervision capacity is strong. Today’s usual argument for caution is to minimize the risk of financial crises. In fact an additional powerful rationale is that crises are particularly harmful to the poor and others in the bottom half of the income distribution. An equity objective of financial liberalization also implies more emphasis on steps to ensure access to credit for all (as opposed to ensuring cheaper credit, which turns out not to work anyway—either for equity or efficiency).

**5. The exchange rate.** The original consensus formulation emphasized the need for competitive rates to increase nontraditional exports. There is still no con-

*continued*

*. . . perhaps because those with influence at the time, in Washington and in Latin America, brought their prior beliefs to what they read and remembered.*

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*Box 1 continued*

sensus on the “right” exchange rate regime, though the weight given to reduced financial vulnerability is higher following the crises of the 1990s. The emphasis is still on competitiveness and stability, central objectives to enhance job creation and protect the highly vulnerable poor and the near-poor.

**6. Trade policy.** Reducing protection of local producers through quotas and tariffs on imports is a step toward efficient and sustainable growth. The controversy is about its effects on equity—left unmentioned in the original formulation. The evidence for Latin America is that more trade is not the culprit in the growing gap between wages of the skilled and the unskilled, though the opening of capital markets may be (because cheaper capital encourages more use of skilled labor compared to unskilled labor). In addition, because the consensus was concerned with domestic policy, there was no mention of the crucial importance for equity in Latin America of the industrial countries reducing their protection of agriculture, textiles, and other labor-intensive products.

**7. Foreign direct investment** brings needed capital, skills, and know-how and so is good for growth—the objective in the original consensus. As it turns out, that means it is probably good for the poor—or at least does little harm. Although it may be a vehicle for increasing wage gaps—that would be mostly by raising wages and salaries of the highly skilled, not by lowering wages of the unskilled.

**8. Privatization.** There is no mention in the consensus of the risks of increasing the concentration of wealth with privatization—where institutional arrangements are weak or vulnerable to insider pressures. Nor is there mention of the positive opportunities to distribute capital more broadly (as in Bolivia’s capitalization program).

**9. Deregulation.** The original consensus emphasized the benefits for competition. Though not mentioned, deregulation can be good only for small businesses and for job creation—and thus for creating jobs and generally enhancing equity.

**10. Property rights.** The consensus included property rights, but without referring to the potential benefits to low-income households from land reform in rural areas and aggressive titling of land in urban areas.<sup>a</sup> The mention of property rights at least opened the window to something we have become increasingly convinced about: growth and equity require not only more room for market forces and private enterprise, but also the strengthening of the institutions that underpin markets, including the laws and judicial procedures that help secure property rights.

a. The author of the original Washington Consensus, John Williamson, confided to us that he added property rights mostly to get to a total of 10 items. In subsequent essays on his original theme, Williamson referred more explicitly to equity issues. He mentioned, for example, the Grameen Bank as a model for microcredit schemes, and discussed land reform under the property rights item in a 1993 article.

*This report proposes “10 + 1” new policy tools to provide an agenda for the region and the international community.*

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an agenda for the region and the international community to match the new rhetoric with visible policies and programs.

Unlike the consensus that Williamson described, we emphasize that there is no such consensus about our 10 plus tools. Indeed, our tools are contentious. We present them because we think they can make a difference. We want them to provoke debate and inspire new commitments—not just among policy makers in Latin America and Washington whose views were embodied in the original Washington Consensus, but also among civil society groups and the broader public, especially in Latin America, who monitor and influence policy in the region’s democratic societies.

### **The 1990s: Economic Reform and Disappointing Results**

In the 1990s Latin America championed the Washington Consensus. Monetary prudence cut inflation to single digits almost everywhere. Fiscal discipline reduced the average budget deficit from 5 percent of GDP to about 2 percent—and lowered public external debt from about 50 percent of GDP to less than 20 percent. Trade liberalization brought average tariffs down from more than 40 percent to nearly 10 percent. Financial liberalization was just as aggressive—with direct credit controls abandoned, interest rates deregulated, foreign direct investment regimes opened, and foreign exchange and capital account controls dismantled. Banks, power plants, telecommunication systems, and even roads and water and health services were sold off to the private sector. More than 800 public enterprises were privatized between 1988 and 1997.

Implementation varied across countries, but the overall quality and intensity of economic reform in Latin America in the 1990s were far higher than at any time in memory. One result was a surge of private capital inflows into the region, from \$14 billion in 1990 to \$86 billion in 1997, before a decline to \$47 billion in 1999 in the wake of the Asian financial crisis. Another for most countries was an expansion of investment and export volumes.

But in economic growth, poverty reduction, income distribution, and social conditions the results were discouraging. Real GDP

*Real GDP growth in the region was low in the 1990s: just 1.5 percent per capita . . . Unemployment rose. And poverty remained widespread.*

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growth in the region was low in the 1990s: a modest 3 percent a year for the decade (just 1.5 percent per capita). That was barely better than the 2 percent (0 per capita) rate in the crisis-laden “lost decade” of the 1980s, and well below the rates of 5 percent or more in the 1960s and 1970s. Unemployment rose. And poverty remained widespread. Latin America entered the third millennium with nearly 180 million of its people—more than a third of the population—living in poverty (with incomes less than \$2 a day). Nearly 80 million people suffer extreme poverty, with incomes less than \$1 a day.

Social development indicators were only slightly better. Rates of infant mortality, literacy, and primary school enrollment all improved in the 1990s. But access to safe drinking water remained very low in rural areas and the quality of public schooling poor. Meanwhile a sharp rise in crime and violence undermined the quality of life everywhere in the region.

In country after country citizens were discouraged, often suffering from what might be called “reform fatigue.” Public opinion surveys in the late 1990s indicated that Latin Americans thought their economies were not doing well, that their quality of life was lower than that of previous generations, and that poverty was higher than ever. People showed great anxiety about jobs and income. This is not surprising given the region’s history of economic volatility, the special disruptions of the 1990s, and growing awareness of such new risks of globalization as that symbolized by the digital divide.

At the end of the decade Latin America still displayed the most unequal distribution of income and assets (including land) of any region in the world. And in the same surveys Latin Americans consistently expressed a sense that the region’s societies were fundamentally unjust—probably reflecting underlying inequity in opportunities for schooling, jobs, and political participation.

The economic reforms are often blamed for slow growth and disappointing social performance in the 1990s. That is hardly justified. Careful analyses indicate that without the reforms the situation would have been worse. Per capita income and output in Latin America would have been lower, volatility higher, and

*The 1990s in Latin America revealed some basic deficiencies in the Washington Consensus. We suggest that the original consensus was simply too narrow.*

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poverty and income inequality deeper.<sup>1</sup> So, an important core of economic policy wisdom encapsulated in the Washington Consensus should endure. Policy makers adopting policies flagrantly at odds with it put their countries in peril—risking permanent damage to social welfare.

But such counterfactual reasoning—that without reform things would be worse—provides little consolation to the poor, the chronically unemployed, and the region’s many concerned and frustrated citizens. It offers little if any wherewithal to mobilize political support for more of the same type of economic reforms. Politicians can hardly expect voters who already feel cut off from economic prosperity—or from the hope of it—to be grateful to their governments for not being as badly off as they might have been.

So the 1990s in Latin America revealed some basic deficiencies in the Washington Consensus. There is much disagreement over where the flaws reside. Some argue that the 10 policy instruments of the Consensus have not been consistently and completely implemented, and that more of the same is needed. Some focus on the mixture and sequencing of the proposals—leading to irreconcilable differences on how best to proceed. Others insist that the fundamental problems have come mainly from outside, and have undermined the region’s progress through what we now call globalization.

In this report we suggest that the original consensus was simply too narrow. We look beyond the Washington Consensus to a new paradigm that explicitly embraces equity and poverty reduction as fundamental objectives—that is, as ends in themselves and as effective means to higher growth.

### **The Shift in Rhetoric**

The shift in rhetoric about economic and social objectives has been dramatic. In formal statements at their summit meetings in 1994 and 1998 Latin America’s heads of states embraced poverty reduction, education, and good governance as fundamental goals—implying a substantial extension beyond the emphasis on adjustment and growth in the Washington Consensus (box 2). Poverty reduction

## *Latin America's poverty and highly unequal access to land, education, and other assets directly contribute to low growth.*

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and equity have come to dominate the development agenda—displacing but certainly not eliminating growth. Support for the new objectives also comes from the international donor community, from other policy officials, and from academics.

This shift responds to at least three factors. First is the evidence that Latin America has made little (if any) progress in the battle against poverty and income inequality. Second is the growing concern about globalization—that whatever its benefits, globalization can also increase volatility, job insecurity, and wage losses for unskilled workers.<sup>2</sup> Third is the accumulating evidence from economic studies that Latin America's poverty and highly unequal access to land, education, and other assets are more than symptoms of low growth—they directly contribute to low growth. In countries with

### **Box 2 The New Discourse on Non-Income Objectives of Development**

In their 1994 and 1998 summits the heads of state of the Americas emphasized the importance of poverty reduction and equity. Other groups are joining them in making non-income development objectives a priority.

- The international official and donor community set specific development targets for poverty, literacy, and infant mortality.
- The World Bank and the Inter-American Development Bank made poverty reduction the overriding objective of their corporate mission. The International Monetary Fund joined the wave, labeling its facility for the poorest countries the Poverty Reduction and Growth Facility.
- The World Bank and the International Monetary Fund linked comprehensive debt relief for the world's poorest and most indebted nations to formulations of these nations' own poverty reduction strategies.

The economics research community, traditionally focused on growth as the key objective, fell in step, too. The Nobel Prize in economics in 1998 went to Amartya Sen for his work identifying human capacities and political freedom as the ultimate objectives (and means) of development. The Inter-American Development Bank released the 1998/99 research report, *Facing Up to Inequality in Latin America*. And the World Bank released the 2000/01 *World Development Report: Attacking Poverty*, highlighting security, empowerment, and opportunity as the three antipoverty pillars.

*Our 10 “equity tools” suggest what governments could do to build more just societies, without sacrificing economic efficiency and growth.*

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weak capital markets, underfunded public schooling, and inadequate judicial systems and poor contract enforcement—in short, in most of Latin America—the poor and the unskilled are likely to be elbowed out of access to credit, to jobs, and to other opportunities to be productive. In a vicious circle their lost opportunities mean lower overall growth and persistent poverty and inequality (box 3).

**10 + 1: A Policy Toolkit for Equity with Growth**

How can Latin America escape its vicious circle? Our 10 “equity tools” suggest what governments could do to reduce poverty and inequality, without materially sacrificing economic efficiency and growth, and indeed in most cases enhancing them. Our tools have to do not only with reducing poverty, but in a larger sense with building more visibly just societies—in which the poor and the middle class, not just the elite, have full access to economic, social, and political opportunities.

Our focus is the domestic policy agenda. But responsibility also lies with the industrial countries—the source of much rhetoric about reducing poverty in the developing world. To emphasize this point we add an additional “plus” item, so that the advanced industrial countries can also turn from rhetoric to action.

***The 10 + 1 policy tools are:***

**1. Rule-based fiscal discipline.** Fiscal indiscipline—when governments consistently spend more than they collect and more than they can easily finance through sustainable borrowing—has high costs for the poor and the emerging middle class. Commitment to fiscal discipline must go beyond idiosyncratic efforts to a healthy budget grounded in transparent rules and procedures.

**2. Smoothing booms and busts.** Booms are better for the rich, busts worse for the poor. Fiscal and monetary policies and tough banking and other financial standards to manage volatility and minimize crisis cannot be improvised. They should be locked in when times are good.

*The tools have to do not only with reducing poverty, but in a larger sense with building more visibly just societies.*

**Box 3 Poverty and Inequality Impede Growth—and Low Growth Makes Poverty and Inequality Worse**

A vicious circle of poverty and inequality impeding growth—and then low growth contributing to poverty and inequality—is particularly worrying in Latin America.

Consider first the latter part of the proposition: that low growth contributes to poverty and inequality. Across countries over the last several decades, GDP growth per capita has been necessary for reducing the number of poor<sup>a</sup>—the most obvious example is China, where growth has been high and the number of poor has been reduced from 28 percent to 5 percent of the population. Economic growth reduces poverty mainly through its effect on employment. Low GDP growth in Latin America has meant limited creation of new jobs in the modern sector—in contrast to East Asia in the 1960s through the 1980s, where employment increased rapidly and, as the labor market tightened, so did wages. In Latin America growth in the 1990s was not employment-intensive, exacerbating the problem. Low growth implied fewer public resources for the kind of public spending—on basic education and health—most likely to reach the poor and reduce inequality in the long run.

Compounding the problem, low growth in Latin America has been combined with unstable growth—an additional obstacle to reducing poverty. The 1980s recession in the region led to more than proportionate increases in poverty. Downturns in the 1980s and 1990s probably exacerbated inequality, too, as some poor people had to sell their land or other assets and withdraw their children from school—undermining future income-earning ability.

In addition, high inequality in Latin America means that whatever the rate of growth, the growth effect on poverty will be less than in countries that start with a more equal distribution of income. To reduce poverty, growth in Latin America has to be either very high or it has to benefit the poor more than proportionately. Growth in the 1990s made little difference for poverty because it was modest to start and it provided only proportionate gains for the poor, at best.

More central to this report, analytical work supports the former part of the proposition above: that high poverty and inequality in turn constrain growth.<sup>b</sup> The effects of poverty and inequality in reducing growth work in several ways. First, high inequality of income and wealth in Latin America has probably, until recently, supported a similarly unequal distribution of political representation and power. For decades unequal political power encouraged unproductive (for society) lobbying for government handouts—and in the extreme, corruption. Used to secure eco-

*Box continued on page 12*

*Opportunities abound for win-win solutions, where inequality or poverty (or both) could be reduced while enhancing efficiency.*

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*Box 3 continued*

conomic privileges, unequal political representation undercuts competition, efficiency, and productivity growth.

Second, poverty and unequal distribution of income and assets have inhibited growth by magnifying the adverse effects of imperfect markets and weak government institutions on savings and investment. Telling examples come from Latin America's weak or incomplete financial markets.

- Poor heads of households are unable to secure loans on the basis of potentially high future income if their children were to stay in school longer. This condemns the children of the poor to limited schooling and low future income. That lowers the human capital stock relative to what it could be and chips away at future growth.
- Similarly, poor farmers and small entrepreneurs have trouble getting credit because they lack real estate collateral. The failure here is a legal and institutional framework that does not recognize movable collateral (livestock, inventory, accounts receivable). Since banks and other lenders cannot be confident of their legal right to seize those assets if borrowers default, they will not accept them as collateral. This eliminates a significant number of socially beneficial investments by micro, small, and medium-size enterprises, eroding capital accumulation and potential growth in the long term.

Ironically, these links show that opportunities abound for win-win solutions, where inequality or poverty (or both) could be reduced while enhancing efficiency. The links mean that reducing poverty and extreme inequality should be pursued as policy objectives in their own right, not simply treated as a hoped-for by-product of growth.

a. A recent study (Dollar and Kraay 2000) suggests that the income of the poor (defined as the bottom fifth of the population) rises about one-for-one with growth in per capita GDP.

b. We do not here address the fact that policies to reduce poverty do not necessarily reduce inequality. Our primary concern is with improving the lot of the poor and increasing the sense of fairness in economic and social life.

**3. Social safety nets that trigger automatically.** A modern system provides an income floor for working and middle class households as well as the poor. During slumps, spending should kick in automatically for emergency public works employment and subsidies to families to keep their children in school.

**4. Schools for the poor, too.** Today's centralized systems reinforce inequality. Critical reforms include more school autonomy,

## *Closing income tax loopholes and reducing evasion would increase revenues without adding to the tax burden of working and middle-income households.*

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lower subsidies to the better-off for higher education, and more public spending on preschool programs. Education policy must also embrace the Internet, with public subsidies to ensure that every school and every community benefit from this revolution in access to knowledge.

**5. Taxing the rich and spending more on the rest.** The region relies heavily on consumption taxes that are regressive. Closing income tax loopholes and reducing evasion would increase revenues without adding to the tax burden of working and middle-income households.

**6. Giving small business a chance.** Weak financial and judicial systems and onerous red tape block talented small entrepreneurs from expanding their businesses. Improved enforcement of credit contracts and shareholder rights, the end of insider credit from state-owned banks, and access to information and professional services would help create more small firms and more jobs.

**7. Protecting workers' rights.** The poor bear the cost of a job contracting environment that has too little worker protection and too many legal rules. Latin America needs more aggressive protection of workers' rights of association and collective bargaining, more independent and democratic unions, and more social protection to replace inflexible rules that discourage job mobility and growth.

**8. Dealing openly with discrimination.** A serious attack on poverty and inequality has to include a visible attack on discrimination. Political leadership can help break down the social and political barriers that hurt blacks and members of indigenous groups—and, in some arenas, women.

**9. Repairing land markets.** A new generation of land reform programs can make rural land markets truly competitive—finally giving the rural poor a fair chance. The new approach emphasizes credit and community involvement and relies less on centralized bureaucracy.

**10. Consumer-driven public services.** Shortcomings in infrastructure, public health, and such regulatory services as consumer protection have cost the poor and the near-poor dearly. Poor and other low-income consumers must now be at the heart of a new culture of service delivery.

## *Our tools are only for economic policy. Yet good government goes well beyond economics to a broader agenda . . .*

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**Plus 1. Reducing rich-country protectionism.** Rich countries' barriers to agriculture and textile imports aggravate poverty and reinforce inequality in Latin America. Lowering them will do the reverse.

### **Why Contentious?**

We have little doubt that the new equity objective is embraced by all. But the right toolkit to achieve that objective is not agreed. The tools we have chosen will not be everyone's favorites. On the formulation of each tool there can be endless debate. What exactly to do—and how to do it—are much more contentious for the items in our toolkit than they were for the 10 instruments of the Washington Consensus.

Moreover, our proposed toolkit has limitations. We cannot suggest that it makes sense in every country. We do not specify an optimal mix and sequencing. If any tool puts growth and equity in conflict, we cannot clarify the right tradeoff. (We doubt that they are in conflict, but we cannot ignore that possibility).<sup>3</sup> Except possibly for fiscal discipline (which we see as necessary, but not sufficient) and education (for which there is already a regional consensus that it is a top priority), we suggest no ranking.

Our tools are only for economic policy—following the lead of the Washington Consensus. Yet good government goes well beyond economics to a broader agenda—of promoting democracy, extending civil liberties, reducing violence, and ensuring the rule of law, all central to equity. With two exceptions we refer to these political and institutional topics only tangentially, when they have obvious links to the economic policies.

The first exception is corruption, which poisons an equity-enhancing strategy (box 4). The second is civil society. Civil society groups in Latin America can contribute to more open and democratic policy making by enlarging the public debate about many policies and programs, especially those we highlight below. We take a positive view of civil society. Despite problems of representation and accountability, civil society can

*. . . of promoting democracy, extending civil liberties, reducing violence, and ensuring the rule of law, all central to equity.*

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#### **Box 4 Corruption Hurts the Poor**

Latin Americans are well aware of how corruption undermines their governments and societies. In Transparency International's latest surveys of local and international perceptions, most countries in the region ended up in the bottom half of the 99 countries covered: Brazil ranked 45th, Argentina 52nd, Ecuador 74th, Venezuela 75th, and Honduras 94th. Only Chile did better, at 19th.

##### ***Corruption poisons any equity strategy***

One of the worst aspects of corruption in Latin America is its role in sustaining inequality and undermining efforts to reduce poverty. How does that process work?

First, corruption undermines competition, and that hurts small businesses, consumers, and taxpayers. An obvious example is corruption in procuring government services. If a few large firms with the right contacts and the capacity to pay big bribes get the inside track, the costs will be paid by others—in higher prices, wasted public money, poor quality services, and lost opportunities for competitive, job-intensive small firms to expand. Less visible but also insidious are the effects on small businesses and consumers of delays at customs, excessive tax and health “inspections,” and so on—much is the result of an environment that encourages ill-paid public servants to hope for side payments.

Second, by undermining competition, corruption reduces the level and the return to private investment. That reduces job creation and ultimately hurts the poor.

Third, corruption undermines government. A weak and ineffective government hurts growth and cannot effectively protect its most vulnerable citizens. Public revenues are wasted on unproductive projects that line insiders' pockets. The benefits of public investments in roads and hospitals are lost to poor maintenance and corrupt equipment procurement. A discouraged civil service loses its sense of public service and responsibility.

Fourth, corruption undermines confidence in government, with pernicious effects. One example: honest but alienated citizens feel justified in evading and minimizing taxes; the resulting smaller tax base means lost opportunities to provide public services on which the poor rely most. Another example is education. Analysis suggests that countries with less corruption spend more on education—presumably because more honest governments spend more on the poor. (It could also be that when governments spend more on education there is less pressure for corrupt practices. Education offers fewer and less lucrative opportunities for corruption than more capital-intensive public spending).

*Box continued on page 16*

*The actual choice to use some or all of these tools will require strong political leadership.*

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*Box 4 continued*

**What can be done?**

Most countries in the region took a critical step in fighting corruption when they opened their economies to global competition. There is nothing like competition from outside to reduce the space for unproductive rent seeking by private firms, and nothing like eliminating tariffs and quotas to eliminate the bureaucratic discretion that invites bribery.

An independent judicial system would help also. Many countries in the region still lag in meeting the standards of due process observed in developed countries, and courts and judges are often vulnerable to political interference and bribery. The same problem plagues other regulatory agencies—bank supervisions, for example, need to be protected from intimidation.

Awareness of corruption, and sensitivity to it, are high throughout the region. Voters are insisting on more accountable government. The media is relatively free and active. Ensuring full public access to government information—about contracts, prices, and regulatory decisions—will help. So will legitimizing the watchdog role of civil society, the press, and independent analysts.

be a force for more effective collective action by the poor and near-poor.<sup>4</sup>

A final caveat: our tools do not address the central political challenge for reformist leaders—how to build the necessary constituency for equity, attractive not only to the poor and the middle class but to the politically important elite. We believe that at least some of these instruments can be made politically appealing and sustainable in most countries. After all, good economics has sometimes also been good politics in the region, even in the short run. But the actual choice to use some or all of these tools will require strong political leadership. And that will have to emerge in each country from a healthy national process of political and social debate.

Still we do not want to be too modest. It is high time to move beyond the rhetoric of equity to concrete instruments—to develop the political backing, to build the institutions, to implement and then to redefine, adjust, and fine-tune the policies. Our equity-with-growth tools, moreover, are a matter much less

*It is high time to move beyond the rhetoric of equity to concrete instruments.*

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of money than of political leadership and rules of the game. And even where money is needed up front—say, for education—using these tools is more a high-return investment than a cost in the usual sense.





## **Part 2**

# **10 + 1 Tools for Social Equity**



# 1. Rule-Based Fiscal Discipline

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**Latin American countries made great progress** in taming budget deficits in the 1990s. But uncertainty persists about whether they will sustain that fiscal discipline when governments change from one administration to another. Some countries suffer because excessively fragmented legislative bodies prevent the formation of stable coalitions or congressional majorities—or because decentralization undermines the capacity to keep overall public sector spending in check.<sup>5</sup>

Fiscal indiscipline—when governments consistently spend more than they collect, and more than they can easily finance through sustainable borrowing—has high costs for the poor. In most of Latin America fiscal laxity has induced governments either to print money, fueling inflation, or to issue large amounts of debt, driving real interest rates to onerous levels. Inflation hurts poor people because their capacity to protect their earnings—through indexed savings, for example—is limited. High interest rates hurt small businesses that rely on local credit markets—and that harms the poor by limiting jobs for the unskilled. In contrast fiscal discipline protects poor people’s consumption and unleashes new investment, reducing poverty by creating jobs and increasing growth.

Fiscal discipline entails holding down deficits in good times—say, to less than 2 percent of GDP—and ensuring that public debt (to finance small deficits) remains at reasonable levels. A country’s commitment to improving equity and reducing poverty must go beyond idiosyncratic efforts that depend on the convictions of a particular minister or administration. To protect the poor fiscal discipline must be a state policy. The best way to accomplish this is to establish institutions and mechanisms that help lock in sensible political decisions about spending.

Maintaining fiscal discipline from one administration to another requires a healthy budget process, fully institutionalized in legal and regulatory systems and in legislative procedures. Each country must define its rules and institutional arrangements to lock in fiscal discipline.<sup>6</sup> Examples include:

- Prohibiting governments from proposing, and legislatures from approving, unfunded expenditures.

*Maintaining fiscal discipline from one administration to another requires a healthy budget process, fully institutionalized in legal and regulatory systems and in legislative procedures.*

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- Putting legal ceilings on total public sector indebtedness to constrain budgets and public borrowing independent of the government in power.
- Enhancing standards and obligations for disclosure of the entire fiscal cycle—budget preparation, approval, and execution—to improve accountability of fiscal authorities at both the central and local levels, and to enable better monitoring by voters.
- Having a credible independent source publish estimates of actual and projected government revenue and expenditures (one example is the U.S. Congressional Budget Office) to provide the public an alternative to the executive branch’s estimates.

## 2. Smoothing Booms and Busts

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**Latin America has for decades been subject** to high financial and economic volatility—triggered by swings in foreign and domestic capital flows, sharp fluctuations in commodity prices (on which many economies are still unusually dependent), and stop-go patterns in fiscal spending. The volatility is much higher than in industrial countries.<sup>7</sup> It has been reflected in pronounced gyrations in the real exchange rate, the real interest rate, the budget deficit, banking system credit, and the growth of consumption, output, and employment.

Volatility is particularly costly to the poor and near-poor—the income of the rich fluctuates more, but a smaller fluctuation for a poor household can be much more costly. The poor benefit less during booms (when those with real and financial assets tend to gain most), and they are the first to lose jobs during busts. Moreover, even the short-term losses to the poor can have long-term implications. Evidence from Mexico and elsewhere suggests that many children who drop out of secondary school to work in bad times never return. So, explicitly and systematically addressing volatility can exploit a vast terrain for win-win solutions—to simultaneously advance the goals of growth, equity, and poverty reduction.

Policies to manage macrofinancial volatility and thus reduce the probability of crises cannot themselves be unpredictable or subject to continual improvisation. Instead, binding rules must be established at the outset to constrain the political game, ensuring that a cushion of adequate savings is built—not squandered—in good times, and guaranteeing that compensatory mechanisms for spending (for example on the social safety net that we discuss below) will be triggered automatically in bad times. As for fiscal discipline, rules and strong institutions are needed to manage volatility.

A country could conceivably mitigate the consequences of volatility through market-supplied insurance, but insurance against macrovolatility is at best thinly supplied in international capital markets. That means putting a premium on self-insurance (private and public savings in good times for use in bad) and self-protection (actions to reduce the likelihood that adverse shocks and sharp fluctuations will occur).

*Smoothing booms and busts requires both fiscal and monetary tools. Fiscal discipline is important, but so are other fiscal rules and monetary policies.*

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Smoothing booms and busts requires both fiscal and monetary tools. Fiscal discipline is important, but so are other fiscal rules and monetary policies.

On the fiscal side:

- Rules to ensure that an additional fiscal effort is undertaken during booms. This would help avoid fiscal contractions and protect access to financial markets in bad times. Specific standards for a “strong” primary budget position—a strong surplus, net of interest costs—during credit booms need to be defined country by country. A balanced budget in good times, which might be adequate for nonvolatile economies, is likely to be insufficient in volatile Latin American economies.
- Stabilization funds to smooth government spending across good and bad times. These contingency funds operate by rules—frequently set by the national congress—stipulating that excess revenues earned during good times will be saved or used to pay down public debt. If saved, the government would draw down the fund in times of revenue shortfalls to help maintain its spending program. The Chilean copper stabilization fund is a good example.

In the banking system—in addition to prudential standards (for capital, provisions, liquidity) that are materially more conservative than those in industrial countries—the focus should be on introducing:

- Countercyclical loan-loss provisioning requirements—to dampen the amplitude of the credit cycle and insulate banking system solvency from volatility. Banks would have to build countercyclical provisions in times of high credit growth and then use them in the downswing of the credit cycle to absorb losses from (downward) loan reclassifications and asset write downs.<sup>8</sup>
- Countercyclical liquidity or reserve requirements. These would also be higher in good times (with buoyant deposit growth) and lower in times of systemic liquidity crunches. They should be complemented by adequate coverage of the monetary supply by international reserves and, if possible, by arrangements (such as the Argentine international repo facility) for automatic access to international lines of credit in the event of a liquidity squeeze.

## *Other policy steps can make the financial sector less vulnerable to volatility, helping it protect the poor from bank failures and sudden collapses of liquidity.*

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Other policy steps can make the financial sector less vulnerable to volatility, helping it protect the poor from bank failures and sudden collapses of liquidity:

- Internationalizing the banking system. Entry of first-rate foreign banks can rapidly enhance the domestic banking system's stability and resiliency. They bring sounder banking practices and access—through the parent bank—to external capital and liquidity. Foreign banks typically operate under the stricter regulatory and supervisory procedures of their home country, setting a high standard in the local market.
- Diversifying debt and lengthening debt maturities. This entails strengthening public sector debt management to generate an appropriate debt amortization profile (reducing rollover risk due to the bunching of repayment due dates) and to avoid sudden increases in the burden of debt from changes in interest and exchange rates. To lengthen private sector debt while limiting instability in capital inflows, Chilean-style reserve requirements discouraging excessive short-term indebtedness should be seriously considered. Prudential banking norms (say, through the provisioning regime) could also be used to prevent firms and households whose income is in domestic currency from taking on excessive debts in dollars.

Beyond fiscal and monetary policies to limit volatility are:

- Continuing efforts to diversify trade and increase foreign direct investment, including negotiating multilateral, regional, and bilateral agreements. These would help build broader markets for nontraditional export products, reducing excessive dependence on a few commodity exports whose prices are subject to large fluctuations. Openness to foreign direct investment makes sense because it is more stable and permanent than such other forms of capital inflows as portfolio investment and short-term debt.
- Diversifying catastrophic risk internationally. Many countries in the region are disproportionately exposed to natural disasters (earthquakes in Central America, hurricanes in the Caribbean). These are particularly disastrous for the poor—destroying homes and livelihoods. Global financial markets offer little help in

*Global financial markets offer little help in managing catastrophic risk in developing countries. But there is room for domestic authorities to cooperate regionally and internationally.*

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managing catastrophic risk in developing countries. But there is room for domestic authorities to cooperate regionally and internationally, with multilateral financial institutions and private firms to create special catastrophe insurance programs. These would tap the international capital markets to insure the domestic economy and its people against at least part of the devastation of natural disasters.

## 3. Social Safety Nets that Trigger Automatically

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### **Social safety nets serve two essential purposes.**

First, some of them protect the many people vulnerable to income losses, especially during economic downturns—including not only the nearly 40 percent of all households that are poor in Latin America, but another 20 to 30 percent of middle-income ones. These programs provide a rescue floor below which working and middle-class households are not allowed to fall. Some programs, such as unemployment insurance and food stamps, protect households hit by sudden disability, unexpected job loss, death of a major breadwinner, and so on. In addition, an arsenal of these and other programs—emergency public works employment, special school subsidies—should unfold in times of increased unemployment and real wage declines. During economic slumps additional spending on these programs should be triggered and funded automatically, as in the advanced industrial economies.

Second, a safety net can minimize the most dangerous risks associated with deep and chronic poverty—such as child malnutrition and lost schooling. Latin America has a long history of uncoordinated programs to help the chronically poor, often driven by populist clientelism and marred by weak, arbitrary, and politically unsustainable funding. But in the 1990s Chile, Colombia, Mexico, and others introduced a new generation of well-regulated and targeted programs (box 5). Take Mexico's Progresa: for \$700 million a year, 0.2 percent of Mexico's GDP, it increases the real income of almost 3 million families by about 22 percent a year—making a substantial difference in such indicators as children's school enrollment.

A good safety net is likely to comprise a wide range of possible programs—food stamps, school feeding, cash grants, unemployment insurance, and emergency public employment (workfare). Each program must meet some critical requirements to ensure that it is both effective and fiscally feasible and credible.

For programs to protect the very poor against the worst risks of deep poverty, three characteristics deserve mention:

- Common-sense targeting. Adequate targeting requires a heavy dose of common sense and a reliable system of information gathering on household living standards. Common sense

*A good safety net is likely to comprise a wide range of possible programs—food stamps, school feeding, cash grants, unemployment insurance, and emergency public employment.*

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#### **Box 5 Two Successful Safety Net Programs**

Mexico's Progresa, started in 1997, now provides school subsidies, nutritional supplements, and cash food payments averaging \$25 a month per family to almost 3 million families, about 30 percent of the estimated poor in the country. Based on community feedback, household information, and geographical targeting to poor regions, Progresa already shows what poverty reduction programs can do for growth-inducing investments in the country's future. For example, enrollment rates of children of eligible households in Progresa locales are now higher than enrollment rates of similar (or equally eligible) households elsewhere.

Between 1995 and 1998 Bolsa-Escola guaranteed a minimum wage income to poor families in Brazil's Federal District as long as their children (ages 7 to 14) attended school regularly. In 1996 the program covered more than 44,000 children (12 percent of public school enrollments that year) and cost less than 1 percent of the district's total budget. Dropout rates among beneficiaries fell to 0.4 percent, compared with 7.4 percent for primary school students in the district. Repetition rates were 8 percent for students in the program compared with more than 18 percent for nonparticipating students. Employment rates of children ages 10–14 fell by more than 30 percent. And the number of street children fell by more than a third.

dictates some geographical targeting to poor neighborhoods and to poor regions, as in the social investment fund programs in Bolivia and Peru and the health insurance program in Colombia. Systems of information gathering—Colombia and Mexico have made good progress—can function only if they allow analysts in and outside government full access to the data and provide for full public dissemination.

- Politically transparent rules to govern how money is spent. Programs have to be immune to clientelism, political manipulation, and corruption in procurement. It makes sense to include nongovernment officials in their governance—or to find other ways to insulate their leadership from political changes.
- Community involvement. Active participation of the community should be an integral part of the program and provide for partnerships with nongovernmental organizations.

*Systematic programs provide temporary income support for working and middle-class as well as poor households. These require careful design to avoid encouraging abuse and dependency.*

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Only a few countries have developed systematic programs to provide temporary income support for working and middle-class as well as poor households hit, say, by sudden job loss. These require careful design to avoid encouraging abuse and dependency. For example, unemployment insurance should be of limited duration, and benefits should not fully replace wages lost. The seeds of permanent programs of temporary support have been planted, however, in such labor-intensive public works programs as Argentina's Trabajar, and in training programs for unemployed youth (Chile's Joven, Brazil's PLANFOR). These are steps in the right direction, though they have been mostly ad hoc emergency programs, not yet institutionalized.

Specifically countercyclical programs are even rarer. Three guidelines for countercyclical programs:

- Automatic kick-ins. Programs need to be established before downturns, with a commitment to maintain steady levels of adequate spending during fiscal tightening. A minimum spending level should always be maintained for such programs as primary education and health. Countercyclical spending should kick in automatically for emergency public work employment and subsidies to families to keep their children in school.
- Sunset clauses. Countercyclical programs need to have clear “sunset” or “exit” clauses to preserve the fiscal integrity of the budget and reduce program vulnerability to political pressures.
- Targeting mechanisms. Countercyclical programs also require targeting mechanisms. For emergency employment programs, self-selection works best—the wage offered must be below the prevailing minimum wage so that the jobs created are of interest only (or mainly) to the population targeted. Chile's emergency public workfare program, which employed millions in its 1980s recession, is a good example.

## 4. Schools for the Poor, Too

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**There is little (or no) consensus** on the tools in our equity kit, with one exception: education. All agree that it is the one tool that no society can afford to leave unused. Just, fair, and democratic societies can be constructed only with good quality education for all. The same is true for more efficient and faster growing economies. And other tools in our kit rely on education for their success.

Given its income Latin America has poor quality education—and an unequal distribution of education, with big gaps between the schooling of rich children and poor. It is the low levels of schooling of the region's poor—a substantial share of the total population—that bring down the overall average. Although the distribution of education has improved since the 1960s, progress has been much slower than it could have been—and much slower than in East Asia. The average education of adults is now about five years in Latin America, compared with nine years in East Asia, where the rich-poor gap is much smaller. In Latin America families who can afford to send their children to private schools do. Even the middle class uses private schooling—often assuming an onerous financial burden for schooling of a quality only slightly better than in public schools.

Across developing countries a poor distribution of education (added to a low average level of education) reduces average income growth. And it is even more decisive in reducing income growth of poor households.<sup>9</sup> In many countries, the wage gap between the educated (skilled) and less educated (unskilled) is rising. Perhaps this is a global phenomenon, but in Latin America the wage gap is especially large.<sup>10</sup> An unusually limited supply of educated workers results in unusually large wage premia for those with higher education compared with their counterparts. Increasing dramatically in the 1990s, those premia have been the major contributor to the continuing increases in overall wage (and thus income) inequality in the region.<sup>11</sup> Moreover, wage gaps may well be magnified with the advent of the information age to the extent that access to the Internet remains unequal.

Latin America's large education gap is an opportunity for substantial gains in the early stages of education reform. By ensuring

*By ensuring that children in poor households have better access to good schooling, the region can achieve both faster overall growth and faster reductions in poverty.*

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that children in poor households have better access to good schooling, the region can achieve both faster overall growth and faster reductions in poverty.<sup>12</sup> Indeed, the region has a golden opportunity to do so for two reasons. First, fertility declines mean that for the next 20 years or so there will be few young people to educate relative to the (still rapidly growing) tax-paying labor force—and a comparably small burden of old-age dependents. Second, access to the Internet can accelerate the reduction of the education gap, eliminating geographical barriers to knowledge and allowing all countries to exploit world-class teaching and learning.

There are good signs of progress to build on. In the 1990s countries in Latin America substantially increased their public spending on education—by 22 percent between 1990 and 1996 alone. Some countries with among the lowest primary and secondary completion rates in the region (Brazil) began to give priority to raising completion rates among the poor. Colombia, El Salvador, and Nicaragua expanded programs, giving more autonomy to rural schools. Mexico and Brazil made valiant efforts to rationalize public spending on university education—Mexico by instituting modest fees at the National Autonomous University of Mexico, Brazil by tying federal funding to publicly available information on student performance.

But progress in education reform is still halting in most countries. And even where there is political will, the institutional constraints are daunting. We call attention to two important areas for the education reform agenda:

- Heads of state must upgrade the importance of nominating the education minister. In forming a cabinet, they have traditionally given priority to finance ministries and monetary authorities, often to enhance their credibility on Wall Street. The “social” ministers, by contrast, tend to be nominated late in the process, often on criteria unrelated to their technical suitability and leadership capacity—to pay back political debts, ensure geographical balance, or satisfy coalition partners. In only a few countries in the region has this custom begun to change. A sign of real commitment to better education will be the qualifications of those chosen to lead the education ministry.

*Heads of state must upgrade the importance of nominating the education minister. And a frontal attack on the digital divide is critical.*

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- A frontal attack on the digital divide is critical. Public action has to be shaped to exploit the Internet as a new vehicle that democratizes access to knowledge and empowers the poor to participate more fully in building their own human capital. Public subsidies must complement market incentives to deliver Internet access to the poor as well as the rest.

*Primary and secondary schooling*

The key policy challenge: reform highly centralized and inflexible systems. How? By combining voice, choice, and standards.

- Voice—radical decentralizing of education services to involve parents and local communities in governing and running schools. Ideally this includes giving these groups control of hiring practices and payroll management, with the central government allocating its expenditures to schools based on the number of enrolled students, compensating for low family income.
- Choice—greater competition by some mechanism. Options include allowing parents to choose among public schools and, through vouchers and other child-based subsidies, between public and private schools.
- Information and standard setting—strengthening the capacity of central government (or in large countries, state and provincial government) in setting standards, measuring results, training teachers, and disseminating information to the public on school quality. A key sign of progress will be when more countries in Latin America administer internationally comparable achievement tests—to provide information on improvements in the quality of basic schooling.

*Preschool education*

Poor children are least likely to attend preschool but most likely to benefit from it. They benefit directly from preschool where attention to their nutritional, health, and learning needs can be so important for their success in primary school and beyond. Poor children also benefit indirectly—because parents (particularly single mothers) have more flexibility to join the labor force. With

*The region's public systems of higher education subsidize the rich. And in many countries the systems are of such poor quality that they no longer attract good students.*

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economic efficiency and equity both potentially enhanced, there is little room for confusion over the needed policy.

- Increase public funding for publicly managed programs and for private childcare and preschool programs, complementing them with parental support to improve child-rearing. Programs need to account for the needs of working women by extending hours and the number of children and parents covered.

#### *Postsecondary education*

The region's public systems of higher education subsidize the rich. Yet they are underfunded in critical areas where their social returns ought to be high, as in science and research (especially in health and agriculture). And in many countries the systems are of such poor quality that they no longer attract good students, even with low or zero tuition and fees. Four policies are needed:

- In public universities, improve cost recovery from students able to pay. Make systems accountable for their budgets and, through transparent evaluation systems, for their performance.
- Extend massive, merit-based loan and scholarship programs to middle-class and poor students attending public and private universities, channeling public funds to students rather than institutions, thus creating healthy competition among universities.
- Diversify public funding to include subsidies to nonuniversity, postsecondary programs, such as two-year colleges and postsecondary technical training, augmenting both the equity and efficiency of public spending on postsecondary education.
- Forge partnerships between the government and private enterprises to facilitate on-the-job training, apprenticeships, and internships—and generate market input to constantly reassess the design, content, and effectiveness of postsecondary programs.

#### *Vocational training*

Many countries have invested heavily in publicly managed systems of vocational training. For the most part these systems are expensive, irrelevant to the constantly changing demands of private industry, and limited in reaching the poor—who barely fin-

*Publicly managed systems of vocational training  
are expensive, irrelevant to the constantly  
changing demands of private industry, and  
limited in reaching the poor.*

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ish primary school. In the 1990s Argentina, Chile, and Paraguay showed that it is possible to take a different path:

- Subsidize demand through voucher-like systems—encouraging small entrepreneurs to develop and supply training. That creates a market for training and broadens access for eligible students.

## 5. Taxing the Rich and Spending More on the Rest

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### **In the 1990s some Latin American governments**

succeeded in broadening their tax base and improving revenue collection. But only a few, notably Chile, made the incidence of government spending more progressive. On the tax side the emphasis was on improving the efficiency of the tax system to increase revenues—without regard for the incidence of the tax burden on different income groups. Progress was thus limited in making the fiscal system more equitable. That leaves considerable room for more effectively taxing the rich, both to increase revenues and improve perceived fairness, and for making government spending more progressive.

#### *The tax side*

Most tax systems in Latin America are not particularly good at generating revenue. Tax revenues average about 18 percent of GDP, compared with 30–50 percent in the advanced economies. (The exception is Brazil, where revenues are 30 percent of GDP.) Changes in tax policy and more efficient tax collection could increase revenues without adding to the tax burden of working and middle-income households. And raising more revenue would allow for increased spending. This is important because in Latin America the proportion of government spending transferred to the bottom half of the population is larger than that population's share of national income. For example, though only 10 percent of government spending goes to the poorest 20 percent of families, that poorest 20 percent has only 4 percent of national income. So, increasing the absolute amount of government spending would make the overall incidence of government spending more progressive.

The second problem is that most tax systems in the region are regressive—that is, they tax an equal or greater portion of the income of poor and middle-income households, compared with rich households. Tax systems are regressive for at least three reasons. Revenues are derived largely from the value-added tax, other consumption taxes, and single-rate payroll taxes. Effective taxation of high-income people is low. And enforcement of corporate and personal income taxes is weak.

*There is room to expand the tax base by increasing effective personal income tax rates without creating negative work or other incentive problems.*

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The value-added tax and other taxes on consumption account for about 60 percent of total revenues in the region, compared with about 30 percent in Europe. Despite various exemptions on such basic necessities as food and medicines, the value-added tax, excise, trade, and other consumption-based taxes tend to be regressive. They collect a higher percentage from the incomes of the poor than the rich, in large part because the poor spend a larger share of their income than the rich.

Payroll taxes—with a rate more than 15 percent in most countries—also are probably regressive.<sup>13</sup> Although payroll taxes in principle finance specific health and pension benefits and can be therefore thought of as “contributions,” the relationship between the value of these contributions and the benefits is weak—given severe deterioration in the quality of health services and erosion in the real value of pensions as a result of inflation.

Meanwhile, personal income tax rates are not progressive in practice. Though statutory marginal rates on earned income are progressive in most countries, with top rates around 40 percent and in some countries higher, the top decile of income earners faces effective tax rates of a mere 8 percent of their income. (Compare that with average effective tax rates on top income earners in the U.S. closer to 30 percent, including federal and state taxes.)

Why the discrepancy? In many countries most households with above-average income are exempt from personal income tax because of relatively high minimum personal exemption levels.<sup>14</sup> Minimum taxable levels and multiple exemptions and other loopholes combine with underfunded and ineffective tax administration, lax enforcement, and widespread evasion to minimize the taxes paid by high-income households. Most problematic are exemptions of income from capital—allowing many high-income households to reduce their tax burden dramatically. It is all too easy to shelter personal income in shadow “corporations” with high expenses.<sup>15</sup>

There is room to expand the tax base by increasing effective personal income tax rates without creating negative work or other incentive problems. Even the fear that taxing income from capital would lead to capital flight is exaggerated. Evidence shows that other factors—unstable prices, poor contract enforcement—

## *Improving tax policy and tax collection should entail diversifying sources of revenue and moving beyond heavy reliance on the value-added tax.*

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are the real sources of capital flight. Indeed, compared to the United States, with effective average rates at 30 percent for higher income households, Latin America is not close to realizing the traditional economists' concern that high tax rates will discourage innovation and investment.

Increasing collections from the few high-income earners (say, the top 10 percent) might not raise much revenue in the short run, compared with increases in the value-added tax. But this should not be an excuse for inaction. Now that the initial round of tax reforms is in place (establishing and consolidating the value-added tax), the democratic governments of the region should put a premium on making tax systems more visibly "fair." Raising the level of personal income subject to tax would have potential to substantially increase revenues. But this step would make many middle-income households (say, the top 50 percent of all households) subject to income tax. So, to improve fairness, increases should be accompanied by visible measures to raise the average effective tax rates on those with the highest income (as well as to increase the efficiency of public spending).

Another kind of visibility would also help: public education campaigns to inform citizens, at all income levels, of the taxes they pay. The region's tax systems are now invisible or unfathomable to many taxpayers (box 6). As a result many poor and working class taxpayers—rather than demanding from their governments the services their taxes finance—still view government as a benign if unreliable dispenser of gifts. Governments and local independent research and policy institutes could provide information on how the tax burden is distributed.

Improving tax policy and tax collection should entail diversifying sources of revenue and moving beyond heavy reliance on (but without undermining) the value-added tax:

- Increase the share of personal income tax in total revenue—not necessarily by raising marginal tax rates but by stepping up enforcement, eliminating loopholes, and reducing the minimum income below which no taxes are paid.
- Reduce reliance on high, single-rate payroll taxes. In many countries, it would make sense to drop payroll "contributions"

*Enforcement is a key step in making tax regimes fairer, because higher-income taxpayers have much higher rates of evasion.*

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**Box 6 Citizens as Taxpayers**

Latin America's heavy reliance on the value-added tax has left many people unaware and uneducated about their rights and responsibilities as taxpayers. Adding to the problem, many workers pay personal income tax through payroll deductions without ever having to file individual income tax returns.

Because the value-added tax and other consumption-based taxes are folded into the price of goods, many consumers in Latin America do not know that they pay taxes with their purchases. This is also true in other regions, but in Latin America an even higher proportion of all revenue comes from these taxes. Independent research and policy institutes could help by publishing analysis of how much tax different income groups actually pay.

A system based on rebate of taxes for those with incomes below a threshold would be more transparent than the current system. Many workers who have paid personal taxes through automatic payroll deductions have no further obligations, particularly given the minimum income rules for paying any taxes. As a result, Latin Americans are rarely conscious of the taxes deducted every month from their paychecks. Because few citizens ever need to file personal returns, they often don't know their pretax income, or what percentage of their wage goes for contributions to pension, health, and other social insurance programs and what percentage goes to general taxes.

If citizens, particularly the working poor, had a grasp of how much they are paying their governments, they could be better mobilized to press for public services and for accountability from their elected officials.

and finance minimum entitlements for pensions and health from general (and progressive) taxation.

- Greatly increase tax enforcement. Peru's success in tax administration in the 1990s indicates that more revenue can be raised without major changes in tax regimes. Enforcement is a key step in making tax regimes fairer, because higher-income taxpayers have much higher rates of evasion.
- Implement other progressive taxes. There are at least three possibilities here. One is to tax property (implying investment in municipal tax administration). A second is a tax on gross assets, which could be treated as a minimum corporate tax (deductible on corporate income tax), as in Mexico.<sup>16</sup> A third,

## *In the interests of equity, more spending on health, education, and public infrastructure makes sense.*

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more controversial, is to establish procedures for taxing income from assets held abroad.

This third possibility requires agreements with the United States and other countries where assets are concentrated.<sup>17</sup> Ultimately such agreements may be important, given a worldwide trend toward lower taxation of internationally mobile capital. Latin America's open capital markets have made it easy for its better-off citizens to shift assets abroad during economic crises. That raises the premium on efforts to tax the income they earn on their foreign assets.

### *The expenditure side: pensions and more*

Substantial improvement can be achieved in sensible redistribution through government spending. In the interests of equity, more spending on health, education, and public infrastructure (such as roads) makes sense. Greater spending could benefit not only the poor (as in Mexico's Progresa) but also the many other households with per capita incomes well below the average—in most countries as much as 70 percent of all households.

It is a question not just of more spending but also more efficient spending. Our discussion of other tools (education and consumer-driven public services) focuses on radical new approaches in those areas to make public spending both more efficient and more fair. (One simple way is to focus more public spending

### **Box 7 Investing in Children in Unequal Societies**

Why should governments intervene at all in the lives of small children, who are clearly the main responsibility of families? And what are the political difficulties of public investment in children?

In unequal societies with high poverty, interventions that help children reconcile equity and efficiency goals. The reforms that promote more competitive markets also make such assets as land, physical capital, information, and education more valuable. Those who already have these assets come to the market game equipped to play. But some, including all too often the children of the poor, arrive at the game without the necessary equipment to play well. Since they are likely to lose, they may abandon the effort to play.

*Box continued on page 40*

*It is in society's interest to step in with programs of early childhood intervention that enable children to build the most important of all assets—human capital.*

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*Box 7 continued*

Where parents cannot ensure their children a fair chance to win (at schooling, jobs), it is in society's interest to step in with programs of early childhood intervention that enable children to build the most important of all assets—human capital. In Bolivia's Integrated Child Development Program, for example, 40 percent of enrolled children initially show stunted psychosocial development. That percentage comes down by half after one year and the mortality rate of enrolled children is much lower than that of nonparticipating children from other low-income families.

These interventions are all the more relevant considering that economic globalization can make the game even less fair in the short run. Without efficient government investment in children there will be too few players and too little competition for the local league to compete in today's global contest.

Why so little intervention? The politics of investing in children are complex. First, the fiscal costs of early childhood programs are immediate and obvious, but the benefits come only later, with less certainty. Second, controversy and uncertainty about the technical issues—what to do, what is most cost-effective, what is the right mix of inputs in what conditions—make extracting resources from the political system difficult. Third, families that could benefit from such investments are not organized, particularly if they are poor and busy with jobs and small children. And taxpayers may lack incentives—they may need government support when old, but no taxpayer will ever again be a child.

Fortunately things are changing. Democracy, decentralization, and the increasing role of civil society are all increasing effective political demand for public investments in children. To make political support more sustainable, policy makers and advocates of these programs can:

- Push for earmarked taxes to fund child programs—earmarking, never ideal, may be necessary given the political realities.
- Build on the initiatives of small community groups, civil society, and local governments.
- Promote a political constituency of consumers by using direct subsidies to poor and working class families for child investments—they would then demand good quality and sustained programs.
- Build a supplier constituency by hiring and training mothers to start and manage their own small day care services, while providing public subsidies to help poor neighbors pay fees for such services.

## *With equity as the objective, improved pension policy calls for expanding coverage to reach more of the poor . . .*

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on preschool-age children in poor households; box 7.) Here we concentrate on a single big-ticket item—pensions—where much public spending ends up concentrated on households with above average income.

Two problems plague pension programs in the region in terms of their effects on equity.<sup>18</sup> First, pensions are far from universal, covering only workers in the formal sector, often excluding those in the informal sector and in agriculture. In addition, many workers, especially women, fail to qualify for pensions because they never manage to document a sufficiently long and continuous affiliation to formal sector jobs. In Bolivia, Colombia, and Peru fewer than 20 percent of workers are covered by pension systems. Limited coverage means the region's public pay-as-you-go defined-benefit systems have turned out to be regressive.<sup>19</sup>

Recently established private defined-contribution systems also have limited coverage. But because they are funded by individual contributions they at least minimize the risk in pay-as-you-go systems: poor uncovered workers subsidize rich covered workers through tax financing.<sup>20</sup>

Second, many countries—including some that have reformed their general pension schemes, typically creating fully-funded, defined-contribution, privately administered systems—have separate systems for civil servants, the military, and employees of state enterprises. These systems are a potentially huge drain on public finances.<sup>21</sup> In some of these separate systems past public sector wage negotiations were often resolved by an agreement to hold wages down in exchange for the government giving benefits in the form of a future but unfunded liability: guaranteed pensions. To protect their benefits, these politically powerful groups have resisted incorporation into the general system.

The resulting public liabilities are probably large—though information is difficult to get, indeed, impossible to get in the case of military pensions. In Mexico the future obligations of the civil service pension system are as high as a third of the reformed system. Some of these obligations will in the end be covered by

*. . . including minimum benefits  
for low-income retirees.*

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future taxpayers. That means poorer workers are likely to have to subsidize more privileged workers.

With equity as the objective, improved pension policy calls for:

- Expanding coverage to reach more of the poor, while maintaining financial viability (for privately managed systems) and avoiding fiscal damage (for public pay-as-you-go systems).
- Including minimum benefits for low-income retirees, if necessary financed from general revenues.
- Through greater transparency and disclosure, promoting informed public discussion of the immediate and long-term costs of civil service, military, and state enterprise pension programs. This is the first step in developing legislation that would reduce the future tax burden of these programs.

## 6. Giving Small Business a Chance

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**Latin America has more competition** and more openness in markets than ever before. But anticompetitive practices still prevail, especially in such nontradable sectors as services and construction. Institutional weaknesses in the financial and judicial systems block talented entrepreneurs from expanding their businesses. Strongholds of a few powerful groups—often family-dominated—use their political influence on weak government bureaucracies to gain economic privileges, systematically biasing the system against the smaller entrepreneur and in the worst cases feeding corruption. This corruption undermines competition by inflicting a huge (indirect) tax on small enterprises (see box 4).

Obstacles to small and medium-size enterprise development worsen income gaps because new small businesses can be an escape from poverty and because small businesses are the greatest source of job creation in the region (70 percent or more of new jobs in most countries).<sup>22</sup> We divide our discussion of how to unleash the creative power of the small entrepreneur into two key areas: broadening access to finance and other aspects of a focused strategy.

### *Broadening access to finance: microenterprises*

Credit schemes supported by nongovernmental organizations (NGOs) and multilateral agencies have made a valuable contribution to the development of microenterprises (fewer than 10 employees). In many countries such schemes have advanced beyond grant-based lending to a second generation of programs that can borrow to lend and are close to achieving financial self-sufficiency—with borrowing and operating costs covered by loan charges. Still, their scope remains limited compared with the staggering unmet need for credit.

Real expansion requires that these schemes become more like banks—with the ability to accept and manage deposits. That in turn implies that they meet minimum standards of capital adequacy and, like banks, be regularly supervised by government regulators. Yet the regulations and supervision standards should, in some respects, be different from those conventional banks must meet. Take Bolivia, which in 1995 established norms to make it

*Governments should develop a regulatory and supervisory framework appropriate to microfinance—encouraging its expansion while ensuring sound risk management.*

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simpler for unregulated NGOs to enter the regulatory system. “Private Financial Funds” have higher (but fewer) standards for provisioning against loan losses. For microenterprises we highlight therefore this one critical step:

- Develop a regulatory and supervisory framework appropriate to microfinance—encouraging its expansion while ensuring sound risk management.<sup>23</sup>

*Broadening access to finance: the small and medium-size enterprise sector*

Nonexistent or restricted access to credit for small and medium-size enterprises (both urban and rural) is a major unsolved problem in Latin America, even in the countries that have made significant progress toward more resilient financial systems. Globalization has made foreign capital more available only for the larger and most reputable firms. These firms can also raise funds from local banks because they are perceived to be safe bets or because of their connections and influence in insider-driven banking systems. Smaller firms, by contrast, find it difficult to obtain finance not just for long-term investment but even for working capital.

Securities markets have not become a meaningful source of finance for business enterprises despite years of efforts, enthusiastically supported by the multilateral development banks, to create the necessary legal and regulatory frameworks. Weak legal protection for minority shareholders, deficiencies in the regulatory framework and its enforcement, inadequacies in accounting and disclosure, and high transaction costs—all these limit the development of capital markets and thus the ability of small and medium enterprises to raise finance outside the banking system.<sup>24</sup>

Governments have tried to redress the poor access to credit by creating public banks that make loans and take deposits directly from the public (“first-tier banks”). But these banks have been plagued with problems of governance and political interference. Relying on government resources and charging low interest rates—and repeatedly forced, on political grounds, to grant debt forgiveness or soften collection efforts—they have nearly always been a continuous and large drain on government budgets. With subsidized

*Legal and regulatory changes would encourage banks to reach beyond the large enterprises and create an environment more propitious to deeper securities markets.*

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interest rates, they too often favor large land owners and well-connected industrialists. And by distorting price signals and incentives, subsidized credit programs have probably slowed the creation of new small businesses and impeded the capacity of existing ones to become competitive.

Legal and regulatory changes would encourage banks to reach beyond the large enterprises and create an environment more propitious to deeper securities markets:

- **Contract enforcement.** Greater clarity and security of the rights of debtors and creditors by reforming the judicial and nonjudicial processes for contract enforcement—including the repossession of collateral—and for corporate restructuring and bankruptcy.
- **Movable collateral.** Reforms to enable the use of movable collateral (accounts receivable, future wage earnings, livestock, machinery, inventories) to secure credit. The needed “repairs” in most civil-code based Latin American systems include changing the law, modernizing the registries, developing self-help, private, nonjudicial mechanisms for collateral repossession, and reforming the court system.
- **Minority shareholder rights.** Protecting these rights to attract investors to public offerings and upgrading accounting and disclosure standards.<sup>25</sup>
- **Debtor information systems.** Encouraging, through legal and regulatory changes, the development of debtor information systems that would drive down the costs of debtor screening and monitoring; this could make the poor viable clients for electronic banking.

In addition, the problem of public banks can no longer be ignored. The priorities:

- **Phase out first-tier public banks** (that lend directly to the public and accept deposits). In such countries as Brazil, where first-tier public banks are the principal source of loans for agriculture and low-income housing, a preannounced transition strategy is needed to encourage viable market alternatives to develop.
- **Insulate public second-tier or development banks** (which do not take deposits but make loans to private banks using gov-

*There should be a major “spring cleaning” of government red tape—regulatory, tax, and bureaucratic intrusions—that affects small enterprises.*

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ernment funds or government-guaranteed borrowing) from political manipulation and take other steps to make their operations market-driven. Until longer-term credit (say, more than three years) is available to smaller borrowers, development banks may still be a necessary crutch for broadening access. But they are a poor substitute for vibrant long-term credit markets. Their management must be upgraded. They have to be protected from political interference. And their lending practices should not be distorted by interest rate subsidies.

*A larger strategy—beyond finance*

Small and medium-size enterprises are disproportionately affected by cumbersome and arbitrarily enforced laws and regulations, poorly-designed tax regimes, costly transport and communications infrastructure, and slow bureaucratic procedures that invite corruption. Their disadvantage in access to information and technology is much greater in Latin America than in the advanced economies. Incomplete information and uncertainty make these enterprises reluctant to invest in learning and innovation—essential if they are to meet market requirements and adapt to international competition, both at home and abroad. And to minimize the costs of regulation and taxes, small businesses often stay informal, further reducing their ability to borrow, acquire new technologies, and expand in the long run.

Most countries in the region have government programs that offer management and technical support for small and medium-size enterprises. But usually these public programs have been of poor quality and excessively supply-driven—failing to focus on new and changing needs of small businesses. The programs, having done little good, have distracted attention from the more fundamental tasks: creating equality of opportunity by reducing bureaucratic obstacles and concentrating on better access to information, technology, and finance.

A change of emphasis is needed in two respects.

- First, a major “spring cleaning” of government red tape—regulatory, tax, and bureaucratic intrusions—that affects small enterprises.

## *Governments should subsidize, but only partly, privately managed programs to improve small businesses' access to markets, information, and technology.*

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Much of the bureaucratic nuisance that hinders small and medium-size enterprise development stems from regulations that have lost relevance but continue to be embodied—often unconsciously—in the inertia of administrative habits. For that reason, and to lend credibility and prestige, a special task force with members from outside the government, that know small business problems, may be necessary. With a firm diagnosis in place, visible and vigorous action should be taken, with emphasis on transparency and the availability of information on government procedures affecting businesses.

- Second, governments should subsidize, but only partly, privately managed programs to improve small businesses' access to markets, information, and technology (box 8).

Public subsidies can be used judiciously—under co-pay and matching grant schemes—to improve small enterprise access to the markets for technical and professional services and, at the same

### **Box 8 Competitiveness and Innovation for Small and Medium-Size Enterprises**

Argentina's Rafaela-Esperanza Enterprise Development Center is part of a new generation of government business development services—with the government program as intermediary. Rather than provide services directly to businesses, the public agency arranges for businesses to use consultants selected through a competitive bidding process. Small businesses pay some of the cost—not necessarily the full cost, but enough to ensure they are committed to using the advice they buy.

The program has helped develop a broader market for business development services in the region. It combines reliance on private consultants with the recognition that small businesses need some subsidy to get the best technical advice. (To cover its full costs, the program would need to increase prices by more than half or shift its emphasis to higher-margin projects—particularly large projects with large companies, which would undermine its fundamental mission to work with smaller enterprises.)

To improve small and medium-size enterprise export performance, another program, the Programa de Reversión Empresarial para las Exportaciones de-

*Box continued on page 48*

*The supported programs would harness the power of the Internet to provide timely information about new markets and technologies.*

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*Box 8 continued*

parts radically from the traditional (failed) export promotion programs. Using a \$27 million grant fund from the government, it requires individual firms to pay half the costs of consultants and other services of approved projects. The projects were initially chosen and the program managed by an international private firm, selected by international tender. As the Argentine team expanded and its members gained training and experience, the role of international experts lessened. In its first two years the program attracted more than 1,000 clients, with the number of approved projects exceeding expectations (despite economic uncertainties in Argentina's main export market, Brazil).

Paraguay's Voucher Training Program for Microbusinesses was initiated to remedy past failures in financing microenterprise training. Program beneficiaries (who run micro-enterprises of just a few employees) receive publicly funded vouchers. They use them to purchase training and other services from pre-qualified private suppliers, who then redeem the vouchers for cash. The program has helped create a market for private training: by increasing the microentrepreneur's buying power, it encourages training institutions to compete to attract clients. Operated by an independent management contractor, the program avoids problems common to this type of initiative when managed by governments—such as failures to reach the beneficiaries most in need, inappropriateness of services, and abuses of the support offered.

time, to foster the development of such a market. The supported programs would harness the power of the Internet to provide timely information about new markets and technologies. Subsidies should go to the firm demanding the service, with participating private firms and the public sector sharing substantially in the costs of hiring consulting, technical, and professional services. Subsidies can help capture the positive social externalities of knowledge accumulation since they encourage smaller firms to coinvest in learning and innovation. Service contracting should be demand-driven to ensure the supplier firm's commitment to quality and reduce the likelihood of supporting the supply of irrelevant or low-value services. Even the overall administration of the program can be subcontracted to a specialized private firm.

## 7. Protecting Workers' Rights

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**Gainful, productive employment is crucial** to enhance equity, income growth, and poverty reduction.<sup>26</sup> But its importance goes well beyond that—making employment a concern of government policy in its own right, not just a means to other ends. Productive employment is not only about income, it is about dignity and a place in society.

In Latin America the labor market, though highly regulated, fails to protect workers. Regulation focuses on job security (for example, mandating certain forms of severance pay) not on rights of association or collective bargaining that would allow workers to negotiate directly with employers. Jobs and wage income are insecure. Training financed by employers is an unusual privilege. And there is little or no public support during unemployment spells—since few countries have society-wide unemployment insurance schemes. The problems are important because in the last decade open unemployment has emerged in Argentina, Colombia, and Venezuela. And everywhere a large informal sector persists—where labor productivity is low and workers lack minimal protection and benefits.<sup>27</sup>

Ironically, severance payments are a costly regulation for workers. Legally mandated severance payments are a poor substitute for unemployment insurance in most countries. Applying only to workers covered by full-benefit contracts in the formal sector, they are often unrealistically generous (normally determined as a function of the most recent salary and the number of years of service), leading employers to find ways to avoid paying them. Severance payments end up reducing job security, as employers prefer to substitute capital for labor, use temporary workers to avoid the severance obligation, or fire their employees before severance payments are vested or become too onerous.

The emphasis in labor market reform in the region in the 1990s was on increasing flexibility for employers through deregulation. But the real challenge is to go beyond deregulation to a proactive stance by government: protecting collective bargaining, providing minimal income security to workers without jobs, and developing policies that encourage firms to upgrade workers'

*To protect workers' rights the legislative and regulatory framework must be simplified to ensure realistic enforcement.*

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skills.<sup>28</sup> These are the ingredients for labor mobility with security—and for new jobs.<sup>29</sup>

To protect workers' rights the legislative and regulatory framework must be simplified to ensure realistic enforcement, and the role of the labor ministry must be redefined. The ministry would move from unrealistic attempts to enforce regulatory minutiae toward information dissemination (say, on economy-wide productivity changes to help guide wage negotiations), broad standard setting (say, for occupational safety), and protection of a fair contracting environment for individuals and for unions.

Specific policies to look for include:

- Stimulate and protect workers' rights to association and encourage collective bargaining (covering wages as well as work conditions) at the firm level, within sectoral or economy-wide guidelines. Provide flexible guidelines for negotiation and conflict resolution. Raise penalties for illegal anti-union practices and ease regulations that discourage the creation of unions within firms. At the same time, establish regulations emphasizing transparency and accountability in labor unions, including public sector unions, to ensure that unions are democratic and corruption-free.<sup>30</sup> Support training programs for union leaders on emerging new demands of their members—such as issues pertaining to women in the workplace—and education programs for union members on their rights and obligations.
- Ensure that the law does not prohibit flexible hiring arrangements. Laws should allow employment contracts for hourly, part-time, and seasonal employment. These contracts should have adequate social protection, proportional to that in the law for open-ended contracts, to prevent large-scale substitution of workers with new contracts for workers with full-benefit contracts.

To enhance the functioning of labor markets so as to foster productivity growth and competitiveness, by increasing labor mobility while reducing uncertainty for workers, governments should:

- Empower workers to adapt to economic change, succeed in multiple career paths, and choose periods of self-employment. Above all, this requires lifelong access to education, training, and

## *Governments should empower workers to adapt to economic change, succeed in multiple career paths, and choose periods of self-employment.*

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retraining. Mexico's program of "education for life and work" provides a good model. A system of skill certification provides a bridge for workers between training and jobs, and from jobs back to formal education. It also requires a stronger partnership between the public and private sectors to better disseminate updated information on job vacancies and develop effective job-search assistance programs. And it calls for the portability of pensions, health care, and other benefits across and between jobs. Developing the financial system to enhance workers' capacity to manage savings throughout their life would contribute much to this.

- For the more advanced economies in the region, develop a system of unemployment insurance (in lieu of severance payments) covering all workers in regulated contracts. The insurance would be financed from workers and employers' contributions, possibly connected to the pension system. Both individual accounts and collective insurance could be combined in the system to widen coverage and limit adverse effects on work effort. To facilitate the constant renewal and growth of the human capital of the labor force, in addition to a major policy emphasis on education, policy makers should:
  - Develop, in partnership with private businesses and educational establishments, scholarship programs for short-term classroom training and on-site apprenticeships, particularly for unemployed youth. Scholarship stipends should be set low enough to avoid discouraging job searches. Partnerships with and participation of private enterprises are essential components of the programs.
  - Enable young people (16 years and older) to work and to attend school. That would offset the pressures to leave school in bad times to compensate for a decline in household income and in good times to take advantage of a booming labor market. Legal or regulatory changes should allow special contracts for young people who attend school—featuring flexible hours, below minimum wages, and greater ease for firing or quitting. School attendance should be required in youth training or apprenticeship programs.

*Governments should establish labor-intensive public works programs for low-skilled workers displaced by economy-wide shocks.*

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And finally, to protect the most vulnerable workers during the troughs of the business cycle, governments should:

- Establish labor-intensive public works programs for low-skilled workers displaced by economy-wide shocks. These programs should be a permanent feature—activated by downturns and deactivated in good times. Wages in these programs should be set below the relevant market to ensure targeting the neediest and to avoid drawing in already employed workers. Successful implementation would require a working network of local and grassroots institutions, free of excessive political interference and able to screen workers and select and develop the programs.

## 8. Dealing Openly with Discrimination

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**While data on racial and ethnic minorities** are poor and the criteria for their classification vary, estimates suggest that indigenous groups account for about 8 percent (40 million) of the Latin American population, and blacks for 29 percent (150 million).<sup>31</sup> In Ecuador racial “minorities” make up 30 percent of the population, in Guatemala 36 percent and in Peru, 40 percent. In Brazil Afro-Brazilians make up 45 percent of the population.

The roots of inequality in Latin America are similar to those in other developing regions. But the contours run broadly along racial and ethnic lines, making them a key to understanding the region’s poverty and inequality. Racial and ethnic differences permeate the region’s socioeconomic indicators. Average education and living standards are systematically lower for minority groups than for the white population. While the incidence of poverty is high throughout the region, it is particularly severe and deep among indigenous and black groups.<sup>32</sup> Their poverty is associated with lower educational achievement and less access to health, other social services, and such basic institutions as the justice system. The “wrong” race and ethnicity are often barriers to advancing in society.

Gender barriers further complicate the situation of indigenous and black groups in Latin America, even though the best-of-the-region data on overall gender equality—political and legal rights, education, access to resources, and social and economic rights—suggest that it is actually higher than the OECD average. The poor performance of indigenous girls in schooling stands in sharp contrast with the general rule that girls do better, on average, than boys in schooling throughout the region. In Guatemala the education gap between indigenous men and women almost doubled in the past 20 years. In Mexico the gender disparity in the illiteracy rate increases as the share of the indigenous population increases in a given municipality.<sup>33</sup> Minority women often suffer a kind of double discrimination. For Afro-Brazilian women in urban labor markets in São Paulo, a lower return to their education and age compared with white men accounts for 50 percent of their lower overall wages.

Societies throughout the region have largely excluded racial and ethnic issues (as well as gender issues within racial and ethnic

*Governments should recognize the problem of racial and ethnic differences in their societies and start sponsoring assessments of racial and ethnic issues.*

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groups) from the development debate, despite the strong correlation between being indigenous or black and being poor and marginalized. That exclusion has contributed to the persistence of a myth that Latin American societies are color-blind democracies.

To be sure, there has been some progress. Brazil has created an interministerial working group to give increased attention to the black population. Ecuador has established a special secretariat dedicated to indigenous matters. And several governments have taken steps to openly address gender discrimination.<sup>34</sup> But progress is far from adequate to deal with the enormous racial and ethnic inequalities.

It is time for the host of complex issues related to race and ethnicity—bilingual education, affirmative action, outright discrimination, police violence—to be vigorously addressed head on. While there are no easy answers to racial and ethnic questions, a silver lining to the problem may be that dealing effectively with discrimination issues—racial, ethnic, and gender—is a matter not so much of increasing public expenditure as of providing leadership to change prevailing attitudes. To lay the groundwork for discussion and formulation of antidiscrimination public policies, the first step is for governments to:

- Recognize the problem of racial and ethnic differences in their societies and start sponsoring assessments of racial and ethnic issues through data collection (censuses) and social science research.<sup>35</sup>

Such efforts are best undertaken with the participation of the affected groups, especially in designing and implementing questionnaires. The availability of disaggregated data by race and ethnicity provides a necessary starting point not only for political and social recognition of diversity and the validation of multicultural and pluri-ethnic states, but also for the analysis of and legal redress for racial discrimination. In some countries it may make sense to institute special rules to encourage minority groups to exploit their political and social rights and push for their own advance. Success with quotas for minimum representation in political bodies for women in Argentina, Paraguay, and Peru suggests the possibility of this kind of approach for minority groups.<sup>36</sup>

*Governments can develop laws and policies that strengthen women's rights as victims of violence, making violent behavior costlier to the abuser.*

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Women as a group also suffer discrimination. We highlight one area where openness and political leadership can make a big difference:

- Programs to protect women against domestic violence. Gender-based violence reflects deep-seated attitudes, and governments can use the bully pulpit to change these attitudes and legitimize civil society and community group efforts. Domestic violence can also be the result of laws that discriminate against the female victim. Governments can develop laws and policies that strengthen women's rights as victims of violence, making violent behavior costlier to the abuser.

## 9. Repairing Land Markets

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**Latin America has the highest land inequality** of any region.<sup>37</sup> Across countries inequality in land ownership is associated with low growth and persistent rural poverty. Moreover, initial concentration of land ownership seems to be associated with tenacious concentrations of income later, even where the economic relevance of agriculture has diminished. This suggests that inequality in the distribution of land affects the evolution of political and social institutions in ways that lock in high inequality.

The unequal distribution of land in Latin America is also bad for growth. Evidence from studies across and within countries shows that smaller farms are usually more productive than the traditional latifundios, both in land yields and incomes per worker. The only exception: very small minifundios, whose owners usually suffer from poor access to credit and inadequate infrastructure and public services. The supervision costs of hired labor on large farms often outweigh their better access to credit and to technical information. On small and medium-size family-operated farms, owners extract high returns from their careful investments—compared with the lower return on some large estates of absentee landlords whose main incentive for agriculture may be a tax break. This is also true if there is a well-functioning land market in which farmers can also rent land. Land ownership has the additional benefit that it provides collateral, making it easier for rural households to borrow for good investments.

Unequal land distribution may seem less relevant today, since only 8 percent of GDP in Latin America comes from agriculture. But nearly 20 percent of the labor force still relies on agriculture, and more than 60 percent of the region's poor lives in rural areas. Moreover, low incomes in the rural sector put downward pressure on the wages of the unskilled in urban areas. Until agriculture is more productive, urban and rural poverty will persist.

Traditional efforts to redistribute land in Latin America have not been successful—either for equity or efficiency. The controversial land reform programs of the 1960s often got bogged down when landowners contested government efforts to expropriate land and disputed proposed compensation. Without solid political support the programs suffered from unsteady and inadequate funding. Even

*In the last decade, Brazil and Colombia have experimented with innovative, community-driven approaches to land reform.*

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where land was distributed new landholding peasants had difficulty getting credit, received little or no technical help, and thus often failed at raising productivity on a sustainable basis.

In the last decade, however, Brazil and Colombia have experimented with innovative, community-driven approaches to land reform. Under these approaches the beneficiaries identify the land, negotiate a price, and purchase it, rather than relying on the government to hand them land acquired through expropriation. The communities, usually assisted by an NGO or an agricultural service agency, are given grants and access to credit to help pay for the land and for investments and startup costs to develop the farms. These new approaches have opened a faster and cheaper path to land reform than the traditional mechanisms, and their success suggests substantial unmet potential for improving land distribution and simultaneously raising productivity.

To succeed these new programs need strong and committed political leadership. Although there is no single model or simple quick solution, past failures show that successful land reform programs work best when steps are taken to make credit, input, distribution, and land markets work better. The priorities:

- The land market. Avoid giveaways of expropriated land. Instead focus on credit and matching grant schemes to enhance the negotiating power of poor households and peasant communities so that they can buy or rent good-quality lands. Eliminate tax and regulatory obstacles that undermine the markets for buying, selling, and renting land.
- Other markets, too. Complement land reform schemes with specific programs to ensure that credit, output, and input markets are working in rural areas. To succeed farmers need access to credit and to seeds, fertilizers, and the latest technical information—usually through publicly funded agricultural extension programs. They also need fair pricing for their products.
- Decentralize implementation and build in collaboration between local governments and all the stakeholders—sellers, buyers, local communities, and nongovernment groups that provide technical and other services to farmers. Successful pilot programs show the need to involve communities and local nongovern-

*To promote equality government should put a high priority on funding for urban land-titling programs.*

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mental groups in planning, beneficiary selection, program implementation, and monitoring.

Urban land markets also need attention in Latin America. In urban areas the economic logic of granting formal titles to squatters is well recognized because it offers security and facilitates investment in home improvements and community-based businesses. To promote equality government should put a high priority on funding for urban land-titling programs. The public sector needs to finance these programs, but experience shows they should be managed by private groups, with appropriate accountability.

# 10. Consumer-Driven Public Services

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## **What are traditionally called “public services”**

(though some are provided by private, usually regulated firms) are critical to the smooth functioning of a market economy. Public transportation, road maintenance, water, sanitation, electricity, telecommunications, pollution control and other environmental services, food and drug safety and other consumer protections, public health including control of endemic diseases—all these have been plagued with problems of funding, access, and quality in Latin America. Shortcomings in these services have cost the poor and the near-poor dearly, because these groups are most dependent on these services. Because of their buying power and privileged access to bureaucrats and regulators, higher-income households have no need to create the healthy political pressure that is key to accountable and responsible “public services.”

### *Infrastructure services*

Access to infrastructure-based services—such as safe water, sanitation, electricity, and telephone connections—has improved in the region over the past fifteen years. But progress has been slow and uneven. Rural areas lag substantially behind urban ones, and the poor are ill-served everywhere. The rich suffer least when these public infrastructure services are deficient—their neighborhoods are usually best served in the first place, and for some services they can resort to private providers. For the middle class and the poor lack of access and low quality are much more costly—in higher health and occupational risks, and in time and income lost, as when electricity is unreliable and roads and bus systems are bad.<sup>38</sup>

### *Regulatory services*

What could be called regulatory services for the nonfinancial sector—pollution control, public health, food safety, and consumer protection—never took firm hold in the region, neither during periods of military control nor later in periods of democracy, when fiscal austerity attenuated any new or expanded government functions. Poor funding, governments’ inability to attract the necessary technical expertise, and the resistance of powerful industrial

*Privatizing has generally resulted in better quality and enhanced availability of services without undue increases in the cost to consumers.*

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and producer groups have all weakened policies and programs to improve these regulatory services. Only a few countries have tackled seriously such issues as pollution control, public health, food and road safety, and other consumer protection services.

*Privatization and beyond*

Until the 1980s infrastructure services were typically state run—supplied at subsidized rates by large public sector monopolies that had no commercial incentive for adequate pricing or orientation to consumer needs. The history of state-run utilities charging inadequate prices left most telecom, water, sanitation, and electricity companies unable to expand and innovate, with visible deteriorations in quality. That ended up undermining social welfare and the lot of the poor—who are always last in line for any subsidized service.

Privatization of telephone and electricity services (and to a lesser extent of road, ports, and airport services) swept through Latin America in the 1990s. (Privatization has not been significant in water, sanitation, urban public transportation, or public health services—it is a less apt solution technically, still less politically.) Privatizing has generally resulted in better quality and enhanced availability of services without undue increases in the cost to consumers.<sup>39</sup> It has also relaxed the bottlenecks that supply shortages of these services used to create. Furthermore, enhanced access resulting from such privatization seems to have benefited the poor, particularly where it allowed for meaningful competition, and even where prices increased. This is so because before privatization the poor, without any physical access to public services, either did without or paid even higher prices to private providers—as for bottled water.<sup>40</sup>

For the most part the approach to privatization in the region has been shaped heavily by the fiscal benefits privatization provides (as sales help shore up government revenues or permit retirement of the government debt). In some cases that has meant insufficient emphasis on ensuring that markets would be competitive after privatization (due to sales to a single firm or to inadequate regulation of natural monopolies once in private hands). It has also

## *Beyond privatization government has a critical role in regulation and consumer information.*

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reflected the reality that privatization policies were never embedded in a broader vision of social policy. In most cases that has meant lost opportunities to exploit privatization as a way to directly distribute to the broader public the benefits of sales.

One exception is Bolivia, where some of the expected benefits of privatization have been distributed in the form of future pension benefits or stock holding to citizens—creating more shareholders in the market economy through a kind of popular capitalism. In contrast, privatization in Brazil, though clearly leading to more efficient and competitive production, failed to provide for any improvement in the distribution of wealth and income (box 9).

### *A new approach*

Beyond privatization government has a critical role in regulation and consumer information. And government will always have fundamental responsibilities in environment, public health, and consumer protection. All these services—infrastructure and regulatory—need a radical rethinking of the culture of service delivery. Public policy and practice need to become consumer-driven—geared toward creating incentives to satisfy consumers and citizens rather than bureaucracies or interest groups. And citizens and consumers have to have the mechanisms to insist on high quality services and on accountability of politicians and officials.

As in education, improving these services is not so much a matter of expanding budgets (the level of spending in Latin America is generally comparable to that elsewhere, at given country incomes). Instead, it is a matter of creating a market in which public financing is combined with a new style of management—one that focuses on greater consumer choice. The government then assumes two major roles. The first is empowering citizens and community groups with efficient regulation and information about standards and prices. The second is ensuring, through voucher-like subsidies and cash grants, that the poor have the buying power to act as demanding consumers.

We set out below policies and programs to look for in infrastructure services, but the same logic and spirit can be applied

## *Bolivia's privatization program put income redistribution at the heart of its process.*

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### **Box 9 Privatization and Popular Capitalism**

#### ***Letting taxpayers hold the bag in Brazil***

Since the early 1990s Brazil has privatized more than 115 state-owned enterprises, transferring more than \$71 billion worth of equity capital to private owners. For efficiency, reflected in improved profitability of privatized firms, privatization has been a success. But its impact on income and asset distribution has been less positive.

To be sure, equity concerns were never at the heart of the program's process or objectives. Although democratization of capital was initially stated as a goal, the Brazilian government—facing a fiscal crisis when the program peaked in 1997 and 1998—focused instead on using privatization to promote foreign investment and maximize revenue from sales. To get higher prices it auctioned most of the state-owned enterprises in large, controlling blocks of shares to big foreign and national corporations. In the few cases where room was made for democratization of capital, the beneficiaries were mostly middle-income workers of former state-owned enterprises participating in manager-employee buyouts and workers covered by pension funds of former state-owned enterprises that participated in the auctions.

Worse, the program did not reduce public debt, which actually increased sharply from 1994 to 1999 due in part to external shocks. Taxpayers, including the poor, will bear the costs of higher public debt for many years.

#### ***Creating stakeholders in Bolivia***

Bolivia's privatization program put income redistribution at the heart of its process and objectives. Under the model adopted in 1995, private purchasers of state-owned firms committed to double the net worth of the companies in exchange for half the shares. The government distributed the remaining half to the Bolivian people in the form of life annuities (initially set at \$250) beginning at age 65. (The annuity represented 27 percent of Bolivia's per capita income.)

The privatization program created stakeholders in the future of the firms and the market economy in Bolivia. Subsequent fiscal pressures eventually prompted the government to cut the annuity amount and to maintain the life annuity (still starting at age 65) only for citizens now older than 55. All others will receive, instead, shares in the privatized firms. Critics fear this will result in the poor selling their shares at low prices, fostering again the concentration of ownership. Whatever the outcome, the program illustrates the potential for combining equity goals with the efficiency gains privatization can bring.

## *Use subsidies—direct to poor households—to strengthen the voice of the poor as consumers.*

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to all the regulatory services. First, a focus on competition and information:

- Avoid privatization programs that squelch competition in infrastructure service delivery through exclusivity or other forms of monopoly privileges granted to operators in privatization contracts.
- Make full disclosure a legal part of contract provisions with private providers regarding access, pricing, users' rights, and performance benchmarks. Encourage monitoring and publication of information on service quality by consumer groups, nongovernmental organizations, and the press.<sup>41</sup>

Second, special efforts to reach the poor:

- When auctioning service provision contracts, build in service obligations on private operators to extend access to poor neighborhoods.
- Use subsidies—direct to poor households—to make infrastructure services affordable and to strengthen the voice of the poor as consumers.<sup>42</sup> In Chile private companies provide water service, and customers pay in full—except for the eligible poor, who receive a subsidy to pay for all or part of the service. That puts the poor in a position to demand quality from the private providers.
- Build in contractual arrangements between service operators and poor consumers to tap the labor of the poor in service delivery. In Argentina the low-income population in some neighborhoods is providing the labor to establish and maintain water connections.
- Eliminate regulations that undercut what would be viable markets reaching poor consumers. In Yemen the government now allows poor communities to tap into already available electricity lines and manage the subsequent distribution and pricing. In other developing countries, eliminating the state telephone monopoly has created a good rental market for mobile phones in poor neighborhoods.

*The right combination of tools in a country is likely to emerge only from healthy political debate, in which leadership and open discourse are key.*

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These 10 tools are all available to policy makers in Latin America. They are an equity toolkit—not a fully specified plan. The right combination in a country is likely to emerge only from healthy political debate, in which leadership and open discourse are key. As that debate advances and new tools are tried, governments can also do well by avoiding mistakes (box 10).

**Box 10 What Governments Should Not Do**

1. Engage in deficit spending—at least not too much or for too long.
2. Assume that the most favorable macroeconomic outcomes will occur in practice. Potential crises always loom on the horizon.
3. Presume that level of expenditure does or will reflect level or quality of outcome—or that expanded efforts and better results can be achieved only with increased expenditure.
4. Ignore the revenue side of public budget. Revenue should be increased fairly—it is impossible to help the poor without adequate revenue and to do it fairly without taxing the better off.
5. Disguise transfers to the better off by identifying them as social expenditures, for example, unduly generous government pensions.
6. Make property a prerogative of the better off. Government should make it easier for the poor to purchase and register property.
7. Forget the unintended consequences of policies, regulations, and programs. Legal protection of job stability may drive employers and employees to the informal sector, with workers left with no protection at all. Educational standards may exclude qualified workers from employment.
8. Subsidize the purchase of consumption goods through below-market prices, particularly those chiefly consumed by higher income households (water and gasoline).
9. Be oblivious to the adverse effects of over-valuation on job creation in urban export industries and on prices to poor farmers for their traded crops, on foreign direct investment, and on the stability of capital flows.
10. Reform the civil service and judicial systems last. Good economic policies and even good new laws can easily be rendered ineffective or irrelevant without reliable and incorruptible civil service and judicial systems.

# Plus 1.

## Reducing Rich-Country Protectionism

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**Better access to rich-country markets** is key to enhancing poverty-reducing growth in Latin America. Donor aid is no substitute for the benefits of open markets in Europe and North America.<sup>43</sup> Ideally, rich countries would ease their barriers and allow the free flow of goods and labor—including those of poor and unskilled immigrants. In Latin America this would reduce poverty significantly, and in North America it would ease labor shortages. The problem is that it is unlikely to be feasible politically. So rich economies should at least open their markets to goods, especially agricultural goods, produced by unskilled workers in the developing world.

Most Latin American governments have made progress in undoing the unduly protectionist agricultural policies that for decades undermined agricultural growth and hurt the poor.<sup>44</sup> Meanwhile though, the industrial countries continue to protect their own “sensitive” markets, especially in agriculture and such other labor-intensive sectors as textiles and leather. These are precisely the sectors where developing countries, by specializing, could create more good jobs for the poor and less educated.

Without greater access to rich-country markets, domestic reform and unilateral trade liberalization in Latin America confront decreasing returns. As a result of high agricultural tariffs and subsidies, OECD countries spend more than \$360 billion in agricultural support to their domestic farmers, who make up less than 5 percent of the labor force. Support for each farmer amounts to around \$19,000 a year in the European Union and United States. The support is greatest for nongrain crops (such as sugar, fruits, and vegetables) and for milk and meat products—all labor-intensive commodities in which Latin American countries could easily specialize.

It is easy to see how agricultural liberalization would benefit the rural poor in Latin America.<sup>45</sup> Eliminating agricultural support policies in OECD countries would shift production away from inefficient producers in the OECD toward lower-cost farmers in the developing world. This would help small producers and increase the demand for agricultural labor there. Higher wages for workers in agriculture could eventually raise wages for unskilled urban

*Eliminating agricultural support policies in OECD countries would shift production away from inefficient producers in the OECD toward lower-cost farmers in the developing world.*

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workers as well. Given the concentration of rural poor in agriculture and the high wage differential between those with and without education in urban areas, this would be good for equity in Latin America. Consumers in rich countries would also benefit. Estimates indicate that the OECD and developing world would be \$160 billion better off, even assuming a slight increase in world prices.<sup>46</sup>

What's the obstacle to reducing protection in rich countries? Politics.<sup>47</sup> The agriculture industry, despite its small share of the labor force in rich countries, is powerful. And in such other protected sectors as textiles, rich-country workers justifiably fear job losses. Despite the high cost to consumers and taxpayers, these workers have been effective in protecting their jobs.

Even so there is hope for liberalization in OECD countries. More attention to job training and other benefits for displaced workers, such as temporarily raising salaries in new jobs to meet old levels, would help. A political boost in rich countries could come from civil society groups. Their call for global social justice could focus more on the trade restrictions of industrial countries.

## Notes

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1. Empirical studies suggest that the economic reforms of the 1990s raised the rate of total factor productivity growth by about 1.5 percentage points, which in turn may have boosted the region's potential output growth to 5 percent a year.

2. The global economy makes it easier for the services of unskilled workers in one country to be substituted by those of lower cost unskilled laborers in other countries, while enhancing the international mobility of the (relatively few) capital owners and highly-skilled professionals.

3. When inequality is as high as it is in Latin America, inequality is probably itself a source of inefficiency, so the likelihood of a tradeoff is smaller. There is plenty of room (inside what economists call the frontier) for achieving both.

4. At the same time, we believe that the constructive inputs of civil society are best enhanced and leveraged when there is also effective and open government. For a clear statement on the potential role of civil society, in alliance with government and the private sector, see the concept paper "Launching of the Foundation of the Americas." Copies can be obtained by contacting Samuel Robfogel at [srobfogel@thedialogue.org](mailto:srobfogel@thedialogue.org).

5. Decentralization to local governments in Brazil and Colombia has transferred centrally collected revenues without transferring spending responsibility and political accountability.

6. Recent examples of movement in this direction are Brazil's and Argentina's Fiscal Responsibility Laws.

7. This is so even if some of its manifestations, such as the variance in the growth of real income and consumption, did not increase in the 1990s over the 1980s.

8. The system of "statistical" provisions recently introduced in Spain (Circular number 9 of 17 December 1999, which came into effect in July 2000) is a useful and interesting example of countercyclical provisions.

9. Income growth of the poorest 20 percent of households is about twice as sensitive as average income growth to the distribution of education.

10. The wage gap results from some combination of skill-based technological change and the integration of goods and capital markets through trade and international capital flows.

11. Wages are the major component of income, so rising wage inequality translates into rising income inequality.

12. The Inter-American Development Bank (1997) estimated that growth could increase by as much as 1 percentage point a year if the average education of the workforce were to rise by 1 year (above trend) over the previous decade. That increase could also reduce the Gini coefficient of inequality by about 2 points over that period.

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13. Economists have generally concluded that, in the long run, the burden of payroll taxes falls on workers, not consumers.

14. The minimums are as high as 10 times the average income in Ecuador, Nicaragua, and Guatemala. Other examples include Honduras, with exemption levels of 5.9 times per capita income, and Brazil with 3.5.

15. The last is a particular problem in Chile.

16. Mexico in the 1990s is a case of successful implementation of using gross assets as the base for minimum tax on capital. But even there it has faced rocky terrain, being tested through the justice system and having been restructured to accommodate foreign investors' concerns. Argentina had implemented it earlier and subsequently repealed it mainly on political grounds. In Venezuela a tax on gross assets led to asset concealment.

17. Enforcement problems may be too easy a rationale for lack of initiative in the international community—among rich and poor countries alike—to help poor countries reduce the costs of capital flight. Privileged insider groups can easily escape local debt obligations and local taxes. One step would be for the United States and other countries to eliminate nonresident alien accounts. The income from these accounts, which invite capital flight, is not taxed.

18. We do not comment here on other valid objectives of pension programs, such as being fiscally sustainable and promoting savings.

19. That is, in an actuarial sense some of the benefits they pay are not covered by the contributions of beneficiaries and will be financed from other tax sources. These systems tend to be regressive where coverage is better. Pension benefit systems based on highest earnings favor the better educated, with rising earnings profiles. The better-educated workers live longer and begin work later in life. The poor contribute over a longer working life but receive a shorter stream of benefits during retirement. Such systems are regressive for other reasons too, depending on the structure of the systems.

20. In addition, some countries that have established fully funded defined contribution systems also guarantee a minimum pension to all affiliates, independent of their contributions (though they do have to have been covered by the system).

21. Eight countries in Latin America (Argentina, Bolivia, Chile, Colombia, El Salvador, Mexico, Peru, Uruguay) have reformed their pension systems for private sector workers. As a result the associated fiscal liability has become explicit, adding a significant and typically rising flow of expenditures to the budget (during a fairly long transition period) and requiring compensatory measures to keep the fiscal deficit in check. (Expenditures are mainly to pay the pensions of retirees covered by the old

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system, which receives fewer or no contributions from workers that move to the new system.)

22. Small enterprises are normally defined as those with up to 10 employees. But in Latin America the largest number of small enterprises are “micro” businesses, with fewer than 10 employees. Medium-size enterprises are often defined as those with between 100 and 250 employees.

23. Banks focused on micro and small lending are high-volume and low-margin businesses that manage high credit risk. So successful microlenders (such as Calpiá Bank in El Salvador) display significantly higher capital-to-asset ratios, have much more aggressive provisioning policies, and use different loan technologies (in terms of debtor screening and monitoring) compared with typical commercial banks. Appropriate prudential norms for microlenders should take these features into account.

24. Tax considerations (unwillingness to disclose real taxable income to fiscal authorities) are another factor that prevents even larger and medium-size enterprises from “going public”—that is, from attempting to raise finance through issuing debt or equity securities.

25. Securities markets require significant scale economies for their development. Hence, regional or subregional capital markets may be the only way to go for the smaller countries. Some steps toward regional harmonization of local securities markets are being explored in Central America.

26. Krugman (1994) singles out productivity, employment, and income distribution as the three things that matter most in economics.

27. The informal sector acts as a cushion (given the absence of unemployment insurance) that expands in times of loss of formal sector jobs. Uncertainty and weaknesses in labor contracting have been associated not only with a large informal sector but also with increased irrelevance of labor market regulations in the formal sector. Labor laws and regulations are often ignored by employers and employees alike because they are obsolete and incompatible with the dynamics of today’s markets. And the plethora of rules is such that even sensible regulations—say, on occupational safety—cannot possibly be enforced by ill-staffed labor ministries. Even if unenforced, regulations that are unrealistic are perceived as a threat that can cause firms to go informal.

28. Most Latin American countries have ratified most of the basic labor standards embodied in International Labour Organization conventions: free association, the right to collective bargaining, minimum working age, the prohibition of forced labor, and the prohibition of discrimination.

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29. Evidence suggests that without skill upgrading integration into international markets would increase wage disparities in the region, probably because capital tends to substitute for unskilled labor but to complement skilled labor.

30. Often the product of old, highly centralized systems for delivering public services, public sector unions (for teachers, health workers, public enterprise workers) have become an obstacle to privatization and political decentralization. Often lacking democratic structures, their militancy and political power bring their members job stability and other benefits, sometimes at the cost of other socially desirable public spending.

31. We use the term “black” to refer to all groups that can claim African descent.

32. Indigenous peoples are one and a half times more likely to be poor as non-indigenous peoples, and almost three times more likely to be extremely poor. In Brazil—one of the few countries with data on the living standards of different racial groups—illiteracy rates for blacks are more than twice those for whites, and the percentage of black households with sewage disposal is 50 percent, compared with 74 percent for whites. Blacks also face greater difficulties in upward mobility and in transforming educational and occupational achievement into income. In Bolivia, Brazil, Guatemala, and Peru, after accounting for other factors, a fourth of poverty and inequality can be attributed to ethnic and racial differences.

33. In municipalities with less than 10 percent indigenous population, the male to female illiteracy difference is only 2 percent. But for municipalities with 40 percent and more indigenous people, the difference jumps to 16 percent.

34. Argentina recently passed legislation requiring that a minimum number (or proportion) of political parties’ candidates or of electoral seats in national or local assemblies be reserved for women.

35. Of 26 countries in the region, only four have adequate data on indigenous and Afro-Latin populations: Bolivia, Brazil, Guatemala, and Peru.

36. There is significant variation in the success of quota laws in Latin America. Success in getting more women elected depends on the detail of the law (that is, whether it’s obligatory; whether it reserves a slot, as in Brazil, or actually requires the slot be filled with a woman; whether the woman must be placed in an electable position, as in Argentina, or merely at the bottom of the list). It also depends on the nature of the country’s electoral system (closed vs. open lists).

37. Gini coefficients of land distribution are on the order of 0.8, where 1.0 is perfect inequality and zero perfect equality.

38. The electricity service coverage has become nearly universal in Latin American urban areas (the share of the urban population with access rose from 92 percent

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in 1986 to 97 in 1996) but only reaches some 60 percent of the rural population (up from 54 percent in 1986). Similarly, nine of every 10 Latin Americans living in urban areas have a connection to water, compared with only five of every 100 people in rural areas. In 1996, for the region as a whole, 80 percent of the population had access to sewage facilities (up from 76 percent in 1986), and there were about 9.5 telephone (main) lines for each 100 inhabitants (up from 5.5 in 1986).

39. Some well-publicized infrastructure reforms (Argentina, Chile, and to less extent Bolivia and Colombia) show that reductions in costs to consumers have not been isolated cases.

40. Privatization often had a short-term effect on reductions in employment—labor had to be shed for the privatized enterprises to restore efficiency and profitability.

41. In some cases having a modern, technically savvy ombudsman or agency might make sense. The person or agency would be a watchdog for the poor and working class, defending the interests of the bottom deciles and accountable to an elected body.

42. This requires a systematic diagnostic effort to guide choices on the type of subsidies (access subsidies, consumption subsidies, cross subsidies), the way subsidies should be targeted (according to consumption levels or to socioeconomic characteristics), and the way they would be provided (vouchers).

43. The countries of Latin America have spoken to this point through their membership in the World Trade Organization, their efforts to negotiate a Free Trade Agreement for the Americas, and their enactment of subregional and bilateral trade arrangements.

44. In Latin America past policies penalized agriculture and other labor-intensive sectors in favor of heavy industry—hurting the poor. Protectionism, price controls, and overvalued exchange rates, among other interventions, meant high effective taxes on agriculture, with resulting urban income gains more than offset by income losses in the generally poorer rural areas. But times have changed. In Nicaragua the removal of internal market distorting policies, combined with rapid technological change, has increased agricultural output growth, raising the country's overall growth rate and contributing to a decline in extreme poverty.

45. There are also benefits for more environmentally sustainable development. For example, under the current regime many developing countries have been forced to depend on the production of primary products from the mining and logging industries to sustain development programs. Such dependence on natural resources creates difficult sustainable resource management problems in the long term and may constrain growth. There are resource management problems related to agri-

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culture (water use, land degradation, and chemical pollution), but technological innovation may make them less burdensome.

46. Initially world prices might rise. As new production comes on line in developing countries, prices could fall back. In the end consumers would likely benefit from lower-cost production. For industrial countries, partly through the reduced burden on taxpayer-financed subsidies to agriculture.

47. The EU and other OECD countries have had difficulty in removing trade restrictions even on exports from the world's 48 least-developed countries—failing to abide by a commitment reinforced at the WTO's High-Level Meeting in 1997. The initiatives that have been approved since then, such as the U.S.'s African Growth and Opportunity Act and the Caribbean Basin Trade Enhancement Act, are considerably weak relative to such commitment.

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