Growth, Employment, and Equity: The Impact of the Economic Reforms in Latin America and the Caribbean

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In the last ten to fifteen years, the Latin American and Caribbean region has undergone the most significant transformation of economic policy since World War II. Through a series of structural reforms, an increasing number of countries have moved from the closed, state-dominated economies that characterized the import-substitution industrialization model to economies that are more market oriented and more open to the rest of the world. Complementary aspects of the process have accorded a new priority to macroeconomic stability, especially lower rates of inflation, and to increasing expenditure in the social area. Policymakers expected that these changes would speed up economic growth and increase productivity gains, at the same time that they would lead to the creation of more jobs and greater equity.

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This paper presents the results of a three-year study by the U.N. Economic Commission for Latin America and the Caribbean (ECLAC) on the impact of the reform process. Overall, we found that the reforms have had a surprisingly small impact if we look only at aggregate regional averages. Econometric evidence indicates the reforms have had a small positive effect on investment and growth and a small negative impact on employment and income distribution. It is only by moving to the country, sectoral, and microeconomic levels that we begin to find evidence of strong effects of the reforms. The reforms fostered investment and modernization, but at the same time they led to significant differences in performance: high- and low-growth countries, dynamic and lagging sectors, a gap between large and small firms, and a shift in favor of transnational corporations over domestic firms. The result was specialization and polarization, with the implied opportunities and challenges.

The reforms have solved some longstanding problems, such as cases of excessive protection and inefficient public utilities. They have opened up unexpected possibilities, of which the most dramatic are the export potential demonstrated by the region and the dynamism of modern sectors, like telecommunications. But they have also exacerbated old problems and created new ones: low rates of investment and productivity growth in many countries and sectors, sluggish employment generation and low quality of new jobs, failure to reduce the high levels of inequality that have traditionally characterized the region, and poor integration of the leading sectors and firms with the domestic economies,

with the consequent widening trade deficits and increased dependence on volatile external capital.

Dealing with these problems requires policies aimed at accelerating economic growth through more investment and faster technological progress, and a social offensive to create jobs and improve equity. At the same time, it necessitates improved macroeconomic management. Policy implementation demands cooperation between governments and the private sector to build institutions able to extend the new opportunities to actors that have thus far been marginalized from the new economies in the region.

In the last ten to fifteen years, the Latin American and Caribbean region has undergone the most significant transformation of economic policy since World War II.[1] Through a series of structural reforms, an increasing number of countries have moved from the closed, state-dominated economies that characterized the import-substitution industrialization model to economies that are more market oriented and more open to the rest of the world. Complementary aspects of the process have accorded a new priority to macroeconomic stability, especially lower rates of inflation, and to increasing expenditure in the social area. Policymakers expected that these changes would speed up economic growth and increase productivity gains, at the same time that they would lead to the creation of more jobs and greater equality.

Have those expectations been fulfilled? It is impossible to make more than a preliminary analysis at this point, since in many cases the reforms

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[1] This paper presents the results of a multi-year project carried out by the U.N. Economic Commission for Latin America and the Caribbean and researchers in nine countries. It is based on the synthesis volume of the project: Stallings and Peres (2000).

are less than a decade old, but our study suggests a number of tentative conclusions. Overall, we found that the reforms have had a surprisingly small impact if we look only at aggregate regional averages. Econometric evidence indicates the reforms have had a small positive effect on investment and growth and a small negative impact on employment and income distribution. It is only by moving to the country, sectoral, and microeconomic levels that we begin to find evidence of strong effects of the reforms. The reforms fostered investment and modernization, but at the same time they led to significant differences in performance: high- and low-growth countries, dynamic and lagging sectors, a gap between large and small firms, and a growing differential between the incomes of the well educated and the rest of the population. result was specialization and polarization, with the implied opportunities and challenges.

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A New Approach to Analyzing Reforms: Macro-Micro Linkages

We are not, of course, the first to study the reforms and their impact. During the last decade, an extensive literature developed on the topic. Our reading of that literature suggests four significant problems: (1) the failure to disaggregate variables so as to evaluate whether economic actors have responded in the expected way; (2) the failure to give sufficient weight to the links between the national and international economies; (3) the failure to consider that the package of reforms and policies may be internally inconsistent; and (4) the scant attention paid to the articulation of the dynamics of employment and income distribution with the rest of the model. This study builds on the earlier literature, but it also presents significant innovations to deal with these four problems. The main characteristic that distinguishes it from other comparative studies of economic reforms is the focus on the interaction between macroeconomic and microeconomic processes. To make significant advances at this time, it is crucial to focus less exclusively on the aggregate, macroeconomic level and more on the microeconomic behavior of firms, grouped by sector, size, and ownership. The resulting groups of firms are affected quite differently by government policies and the world economy. Knowing what lies behind the aggregates is essential for designing policy measures to improve future economic performance.

Given the centrality of economic actors for our approach, we start by considering the reforms as a set of signals in the form of government

policy decisions. When governments want to change the way their economies (and societies) operate, they make policy decisions and transmit them to the relevant actors; these decisions constitute our signals. The governmental decisions are essential for creating a new environment in which the private sector can operate more dynamically. In addition, however, in decentralized economies, we need to be concerned about the reception of signals at the microeconomic level and actors' ability to respond to them.

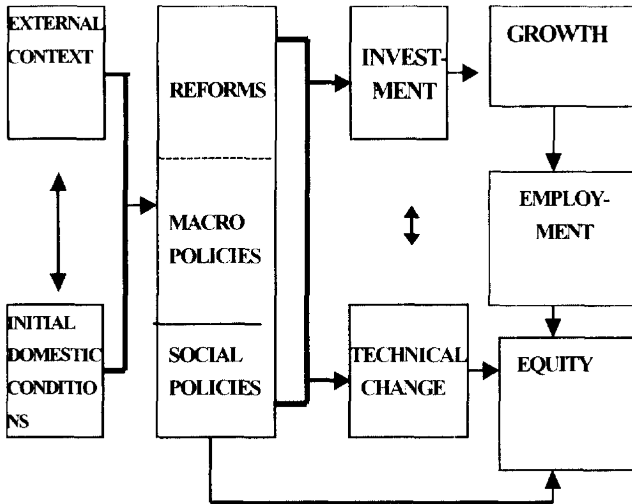
Conceptual Framework

Our conceptual framework (see figure 1) begins with the external context, which we model as variables related to international finance and the demand for Latin American exports. The past performance of these and other international variables helped to determine the initial domestic conditions (economic, social, and political) in each country; in the present, external factors make certain policy choices more likely than others. Moreover, external finance facilitates investment and technical change processes, while international demand and the vagaries of financial flows have an impact on the dependent variables, especially growth rates.

We take initial conditions as given, rather than trying to explain them, but they are crucial in determining both policy choice and response. From the perspective of policy choice, we are be particularly interested in several economic variables, including growth and inflation rates, the structure of output and employment, and links with the world economy. Social characteristics of the population and the ability of governments to make and implement policy decisions are also important. At the firm

level, the accumulated learning and productive capacity are elements that governments must take into account.

Figure 1. *Conceptual Framework to Study the Impact of the Economic Reforms*



The three dependent variables of the model are growth, employment, and equity. Growth in the post-reform period is compared with that of a 1950–80 base period, and its components (capital accumulation, labor accumulation, and productivity) are analyzed in a growth-accounting framework. The characteristics of the growth process (the types of firms that are expanding output dynamically or lagging behind) and the decisions on the type of technology to be incorporated will determine employment generation; the latter is disaggregated by productive sectors and size of firm. Employment, in turn, is a central determinant of income distribution.

Six Propositions

We use this framework to explore six propositions, which take as a point of departure the consensus judgment on the impact of the reforms: growth has been modest; employment has grown slowly and with problems in job quality; and inequality has not improved and may even have gotten worse. The propositions offer explanations for why performance has not been better.

- The initial conditions in the various countries were quite diverse and affected the extent to which reforms were adopted.
- Governments frequently introduced reforms that were inconsistent with their macroeconomic and social policies.
- The reforms were slow to produce an impact at the microeconomic level because of the great uncertainty they generated, especially if they were combined with macroeconomic instability.
- The uneven response of actors helped to explain both the less-than-hoped-for performance to date in most countries in the region, as well as the differential performance across countries.
- The positive effects of reforms were frequently undermined by unfavorable trends in the international economy.
- The reforms were incomplete in that they lacked the proper institutional support necessary to make them work adequately.

The book focuses on nine countries (hereafter “project countries”), which were selected because they had the longest history of implementing economic reforms. Four of them—Bolivia, Chile, Costa Rica, and Mexico—have reforms that date to the mid-1980s or, in the case of Chile, to the mid-1970s. The other five—Argentina, Brazil, Colombia, Jamaica, and Peru—began their reforms in the early 1990s,

although Argentina had a brief experience with reforms in the 1970s. The countries were selected for their reform history, they also represent the vast majority of the population, economic output, and international trade of the Latin American and Caribbean region.

Contradictory Effects of the International Economy

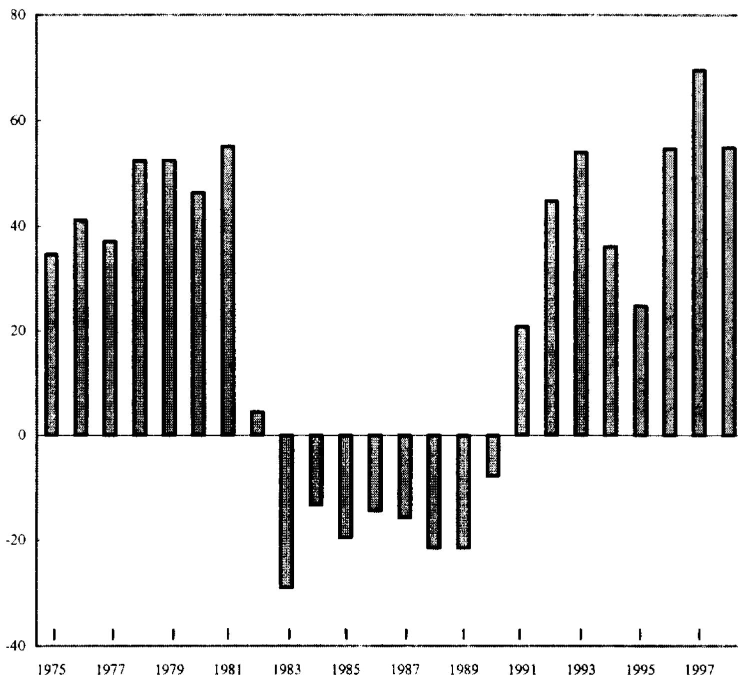
A number of key elements in the international environment have greatly influenced the impact of the reforms on economic performance. With respect to world trade, the value of Latin American exports in the postwar period experienced a clear rising trend, although the region's share in total world exports fell until some recovery occurred in the 1990s. It can be hypothesized that the recent acceleration in the growth of exports is partly explained by the economic reforms. Nonetheless, the increased growth of exports (in volume as well as value) has not led to a comparable growth of output. Moreover, despite the rapid growth of exports, imports have grown even faster, leading to widening trade deficits. These deficits must be financed by foreign capital.

Global capital flows have also increased rapidly, and in this case Latin America's share has grown. These trends are found with both portfolio flows and foreign direct investment, although the former has grown more rapidly than the latter. A key feature of capital flows to Latin America has been their volatility, and the cycles of surges and steep declines became more frequent in the 1990s (see figure 2). Crises were also more frequent, and higher volatility led to uncertainty, which discouraged investment that is crucial for allowing reforms to bear fruit and lead to higher growth in the future. Far more clearly than in the case of trade, levels of capital flows and GDP growth seem to be closely

correlated in Latin America. When capital flows increase, growth accelerates; when they fall significantly or are reversed, growth falls.

Figure 2. *Net Capital Inflows, 1975–98*

Billions of 1990 dollars[a]



Sou

rce: Griffith-Jones (2000), on the basis of ECLAC data.

[a] Data were deflated by the U. S. consumer price index.

There is an important relation between trends in trade and capital flows. One reason that Latin America exhibits a weak link between exports and growth of GDP is that the creation of such a link requires time to develop supplier networks. That is, investment must occur in many sectors and

firms of different sizes, including small and medium-size suppliers, in order for large exporting firms to transmit growth to other parts of the economy. If the volatility of capital flows is such that the investment process is frequently interrupted, the necessary incentives will be absent. Of course, perfect conditions will never exist, but the volatility in the 1990s may have been exceptional. The highly problematic experience with capital flows in the 1990s, and much of the recent literature on the subject, raises the possibility that large surges of easily reversible capital flows may have net negative effects on long-term growth and development. This is in contrast with growing empirical evidence that foreign direct investment and (potentially) trade contribute to long-term growth.

First Generation Structural Reforms

The structural reforms can be defined in a variety of ways. We chose to concentrate on a package of five reforms that were prevalent across the region, while acknowledging that others could be added to the list and that some additional reforms were quite important in individual countries. Our five are as follows: liberalization of imports, liberalization of the domestic financial system, opening the capital account of the balance of payments, privatization, and tax reform. The common element among them was greater reliance on market mechanisms, both domestically and internationally.

Reform Indexes

To study the five reforms, the project built upon previous work at the Interamerican Development Bank to create a set of indexes for analyzing

and comparing the implementation process. This gave us the capacity to study the impact of the reforms through econometric and other kinds of analysis. The indexes measure the degree to which the economy is more open and more market-led, with scores ranging from 0 to 1. While a score of 1 indicates the greatest degree of openness or market orientation, relative to other countries, it is crucial to note that a score of 1 is not necessarily ideal; it may well be that a somewhat lower score would lead to better performance, at least on some variables. Table 1 shows the pattern of the reforms in the 1970–95 period.

Table 1. *Reform Indexes, 1970–95*[a]

	Import liberalization	Financial reform	Capital account opening	Privatization	Tax reform	Average
1970	0.501	0.315	0.588	0.773	0.198	0.472
1975	0.567	0.329	0.543	0.773	0.269	0.493
1980	0.662	0.439	0.567	0.745	0.307	0.548
1985	0.652	0.448	0.545	0.696	0.348	0.541
1990	0.803	0.725	0.683	0.722	0.445	0.638
1995	0.946	0.927	0.848	0.804	0.573	0.821

Source: Morley, Machado, and Pettinato (1999).

[a] Sample includes the nine project countries plus Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Paraguay, Uruguay, and Venezuela.

Aggressive vs. Cautious Reformers

Within the overall reform process, it is possible to identify a set of countries that were "aggressive" reformers versus others who were more "cautious" on the basis of the speed and scope of the reforms. The former group undertook many reforms in a relatively short period of time, while the latter implemented reforms more gradually. These differences were

closely correlated with initial conditions in the period preceding the reforms. Four elements, in particular, influenced policy choice: prior growth performance, inflation, degree of economic distortion (here measured by the reform index), and level of governability.

These elements tended to cluster. At one extreme, Argentina, Bolivia, Chile, and Peru scored poorly on all four elements (see table 2). On average, the four had annual inflation rates of over 1,200 percent in the five years preceding the initiation of the reform process. GDP in those same periods contracted by an average of 0.7 percent. The reform index indicated a high level of economic distortion, and governability had broken down substantially. The consequence of these traumatic experiences was to create an environment in which governments and other important actors were willing to experiment with drastic changes in economic policy.

Table 2 also delineates the initial conditions of the cautious reformers: Brazil, Colombia, Costa Rica, Jamaica, and Mexico. The contrast with the aggressive reformers is quite stark. Average inflation among the five countries in the preceding period was much lower at 168 percent, while the previous growth rate was much higher at 3.0 percent. The level of economic distortion was lower, and problems of governability could not match those among the aggressive reformers. Another way of viewing the difference between the two groups is that among the cautious reformers, the central actors believed the countries were basically sound and had much worth preserving. The particular source of pride varied. For Brazil and Mexico, it was a powerful industrial sector and economies among the dozen largest in the world. For Colombia, it was a historical reputation for sensible policy decisions and a stable economy. For Costa Rica, it was a popular set of social benefits that underpinned a vibrant democracy.

Table 2. Initial Conditions among Aggressive and Cautious Reformers

Country	*Year*[a]	*Inflation*[b]	*Growth*[c]	*Reform index*[d]	*Governability*[e]
Aggressive reformers					
Argentina	1989	1191 (4924)[f]	-1.3	.664	Low
Bolivia	1985	1100 (8171)[f]	-1.9	.445	Low
Chile	1974	228 (609)[f]	1.8	.316	Low
Peru	1990	2465 (7650)[f]	-1.5	.484	Low
Simple average	...	1246	-0.7	.477	Low
Cautious reformers					
Brazil	1990	708	4.4	.696	Medium
Colombia	1990	26	4.6	.689	Medium/ High
Costa Rica	1986	27	2.0	.524	High
Jamaica	1989	14	1.9	.560	Medium
Mexico	1985	66	2.0	.578	Medium/ High
Simple average	...	168	3.0	.609	Medium/high

Source: Authors' calculations, on the basis of project data.

[a] Year reforms began.

[b] Consumer price indexes, December-December, averaged for five years preceding reforms.

[c] Average annual growth rate of GDP, measured in constant 1980 dollars, for five years preceding reforms.

[d] Index reported in Morley, Machado, and Pettinato (1999) for year reforms began.

[e] Authors' evaluation of governments' ability to make and carry out policy decisions at the end of the pre-reform period.

[f] Inflation in the year of highest price rises near the beginning of the reform period.

Among the cautious reformers, Brazil and Mexico had serious macroeconomic problems that eventually led to foreign exchange crises

and devaluations. The others cautious reformers, while not without their own difficulties, did not approach the disequilibria of the other two groups. The resulting categories—aggressive reformers, cautious reformers with macroeconomic problems, and cautious reformers with stable macroeconomic conditions—are useful for analyzing other topics in the book, especially investment and growth patterns. The three groups also took somewhat different approaches to macroeconomic policy.

Macroeconomic Policies and Outcomes

The structural reform process in Latin America and the Caribbean did not take place in a vacuum. The most important factors influencing the impact of the reforms, beyond the content of the reforms themselves, were the international context and the macroeconomic policies of the respective governments. The new valorization of macroeconomic stability in the region over the last fifteen years was as important as the change in development model. (Table 3 shows a set of macroeconomic indicators for the 1980s compared to the 1990s, a proxy for the post-reform period.)

A set of stylized facts characterized the macroeconomic policies that accompanied the structural reforms. First, there was a narrow focus on lowering inflation to the one-digit level or even to the average of the industrialized countries. Second, fiscal policy supported the fight against inflation by shrinking deficits; this was done primarily by cutting expenditure rather than by raising taxes or other revenues. Third, monetary policy was also geared toward stabilization, although it could be expansionary if the demand for real money balances rose. High interest rates were a key instrument of stabilization, in combination with both floating exchange rates and fixed or semi-fixed schemes. Finally,

exchange rate policy was more diverse. In some countries and in some periods, the exchange rate was used primarily to lower inflation; in an increasing number of cases, it was set in order to maintain international competitiveness and stimulate growth. The shift from the former to the latter approach usually proved to be traumatic.

While stabilization policies had an undeniably positive impact on inflation, they also contributed to restraining growth rates in the short and medium run. Moreover, they were procyclical, as interest rates were raised and fiscal expenditure cut to slow price increases, protect the exchange rate, or deal with balance of payments problems. Expansion of output thus displayed a stop-go pattern in the 1990s, both for the project countries as a group and for most of them individually.

Table 3. *Macroeconomic Indicators, 1991–98*[a]

Percent

Indicator	*1983 -90*[b]	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
Inflation[c]	537.1	98.0	149.0	291.9	115.8	19.4	12.7	8.6	8.2
GDP growth[d]	2.0	4.1	4.2	4.7	5.8	2.5	2.8	4.5	2.6
Fiscal balance[e]	-4.4	-0.7	-0.4	-0.3	-0.1	-0.9	-2.5	-2.8	-3.1
Current account[f]	-4.0	-1.9	-2.8	-4.9	-3.1	-3.4	-3.6	-4.6	-5.5
Real interest rates[g]	143.4	24.8	32.6	37.6	15.2	17.7	15.4	19.6	21.2
Real exchange rates[h]	107.4	100.4	100.1	99.2	98.4	100.2	93.7	89.0	89.4

Source: Project database, on the basis of ECLAC and IMF statistics.

[a] Simple averages for the nine project countries.

[b] Period is 1988-90 for interest rates and 1987-90 for exchange rates.

[c] Variation in consumer price index, December–December.

[d] Based on constant 1980 dollars.

[e] Percent of GDP; non-financial public sector except Chile and Costa Rica (central government only).

[f] Percent of GDP; based on constant 1995 dollars.

[g] Average annual short-term lending rates to businesses, deflated by the consumer price index.

[h] Average of the indexes of the real exchange rate for the currency of each country against the currencies of its main trading partners, deflated by the consumer price index; 1990=100.

As table 3 shows, growth rates peaked twice in the decade, in 1994 and 1997, and each peak was followed by a sharp decline. Attempts to control inflation and regain investor confidence after large devaluations were important causes of both declines. Stabilization policies were also associated with temporary recessions in individual countries. When these stabilization episodes coincided with the initiation of the reforms, the resulting slowdown or contraction in growth contributed to a delay in investor response.

Links between Reforms and Macroeconomic Policy

An important question to ask about the reforms themselves as well as about the relation between the reforms and macroeconomic policies is whether they have been consistent and mutually reinforcing, or whether they have been so contradictory as to undermine the effectiveness and credibility of the package as a whole. The evidence leads to a mixed conclusion, across both countries and time periods and also across reform and policy areas.

Consistencies

At the most general level, the trend toward a more equilibrated macroeconomic policy stance, together with a set of reforms that opened new opportunities to the domestic and foreign private sectors, gave an important psychological boost to entrepreneurs; in Keynesian terms, it raised animal spirits. The reforms-cum-macroeconomic stability also ended the external financial constraint that had crippled the region during most of the 1980s. At a more specific level, the most successful mix of reforms and macroeconomic policy occurred in the area of inflation. Governments generally targeted macroeconomic policy at taming inflation. Trade liberalization supported these efforts through lowering the prices of inputs and constraining the ability of local business to raise their own prices. Privatization helped to lower inflation through a positive impact on fiscal deficits, although those governments that used privatization revenues to increase spending tended to run into trouble later on.

Inconsistency Syndromes

Other areas displayed significant contradictions among reforms and macroeconomic policies. Our case studies point to three principal "inconsistency syndromes." The first involved opening the capital account, which produced a rush of short-term capital into the countries and led to appreciation of the local currency. The appreciation made imports cheaper and exports more expensive, thus increasing the trade deficit. It also sent mixed signals to firms that had been encouraged by the trade reforms to invest in new capacity oriented toward exports. While the trade deficit could be covered in the short run by the very

capital inflows that caused the appreciation, the flows were reversible and could leave the country as quickly as they entered in response to domestic problems or international financial trends. In the best of cases, the capital outflows caused disruptions in the local economy; in the extreme, they resulted in currency crises that were extraordinarily costly and took years to overcome.

A second syndrome centered on financial liberalization and monetary policy, which became more difficult to manage if accompanied by capital account opening. Financial liberalization resulted in higher interest rates. Overshooting was quite typical, leading to local interest rates substantially higher than international rates. This was especially problematic for small firms that did not have access to the international markets. Even more important for the economies as a whole were problems that financial liberalization caused for the banking sector. Local banks lacked experience in evaluating long-term credit risks and became overextended when large amounts of foreign capital entered countries. Particular problems resulted when borrowing occurred in foreign currency, since debts ballooned when the reversal of capital inflows forced a devaluation. In this way, banking crises merged with currency crises.

The third syndrome involved fiscal policy. All governments in our study sought to lower or eliminate their fiscal deficits, but several of the reforms made this more difficult. One was tax reform, which lowered rates on individuals and corporations. Another reform that interfered with lowering fiscal deficits was import liberalization. This was especially important for the smaller and less-developed countries that relied heavily on tariffs as a source of government revenue. A third reform, decentralization, exacerbated the fiscal deficits of the central governments by transferring revenues to provinces and municipalities without always transferring the counterpart

obligations. As mentioned above, privatization could help fiscal policy in the short run, but it created its own trap later on.

Social Policy and Social Expenditure

Social policy was an integral part of the reform process from the beginning, at least in principle. The basic idea was to get the government out of productive activities, where the private sector could do a better job, thus freeing public resources for social expenditure. These policies were widely perceived as having double value: they would lead to higher productivity and better economic performance at the same time that they increased equity and mobility in very unequal societies.

Revival of Social Expenditure

Social expenditure declined in most Latin American and Caribbean countries in the 1980s, reflecting the urgent need to reduce fiscal deficits. To differing degrees and with differing emphases, countries gave greater priority to the social area in the 1990s (see table 4). All nine project countries increased per capita social expenditure; except for Peru, the increase more than made up for the decline of the 1980s. After taking account of inflation, the average rise in social expenditure per capita between 1980–81 and 1996–97 was 25 percent. Social expenditure as a share of total public expenditure followed a similar pattern, with an average increase of 23 percent. Finally, social expenditure as a share of GDP also rose in most countries, but at a slower pace (13 percent) than for the other two indicators.

Beyond the issue of the quantity of social services, Latin American countries at the beginning of the 1990s had serious problems with the

Table 4. *Changes in Social Expenditure, 1980–97*

1997 dollars and percent

	Per capita Social expenditure			*Social expenditure as share Of total public expenditure*			*Social expenditure as share of GDP*		
Country	*1980–81*	*1990–91*	*1996–97*	*1980–81*	*1990–91*	*1996–97*	*1980–81*	*1990–91*	*1996–97*
High spending									
Argentina	1378	1222	1570	50.1	62.2	65.1	16.7	17.7	17.9
Brazil	368	476	566	44.4	51.0	54.2	9.7	11.0	11.8
Chile	558	451	725	62.4	60.8	65.9	18.4	13.0	14.1
Costa Rica	487	445	550	66.0	64.4	65.1	19.5	18.2	20.8
Medium spending									
Colombia	156	181	391	27.2	29.7	38.2	7.8	8.1	15.3
Jamaica	194	234	244	22.8	26.8	19.2	n.a.	9.2	9.7
Mexico	333	283	352	28.8	41.6	52.9	7.9	6.5	7.8
Low spending									
Bolivia	60	55	119	34.6	25.8	44.2	5.6	6.0	12.0
Peru	133	41	76	23.6	14.3	37.5	4.6	2.0	6.0
Simple average	407	376	510	40.0	41.8	49.1	11.3	10.2	12.8

Source: Mostajo (2000), on the basis of the ECLAC Social Development Division database.

quality of those services. To deal with the quality problems, many governments in the region began reforms in the social area. While some of the new policies were parallel to the economic reforms, others embodied quite different approaches. One type of reform involved improving the central government's delivery of services in education, health, housing, and social security through better training of personnel, better facilities, more participation of beneficiaries, and so on. A second focused on the decentralization of social services to municipal and provincial levels of government, especially with respect to education and health. The third approach was the one most closely related to the economic reforms since it involved privatizing certain aspects of the delivery of social services. Specifically, a number of countries encouraged the establishment of private schools, health care, and pension systems for those who could afford to pay, leaving the rest of the population to rely on the public system.

Links with Other Policies

These social policy trends were not independent of the economic reforms and macroeconomic policies that were examined earlier. The 1980s manifested clear contradictions between macroeconomic and social policies. When the need to reduce fiscal deficits collided with the need to expend resources to achieve social and economic goals, the macroeconomic priority usually won out. In the 1990s, the contradiction was less severe as deficits had been reduced and governments became more aware of the benefits of social spending. The economic reforms contributed through the sale of loss-making state firms and additional revenues from privatizations. Whether social policies will continue to

coexist harmoniously with reforms and macroeconomic policies remains to be seen.

A major conclusion is that the structural reforms must not be viewed in isolation but rather as part of a policy package that includes the macroeconomic and social areas. These three elements can work together to create a propitious environment that encourages private sector actors to invest and increase output, or they can be contradictory, thus sending mixed signals and undermining incentives for the private sector. In addition, international economic trends will have an impact on all three.

Reforms, Investment, and Productivity

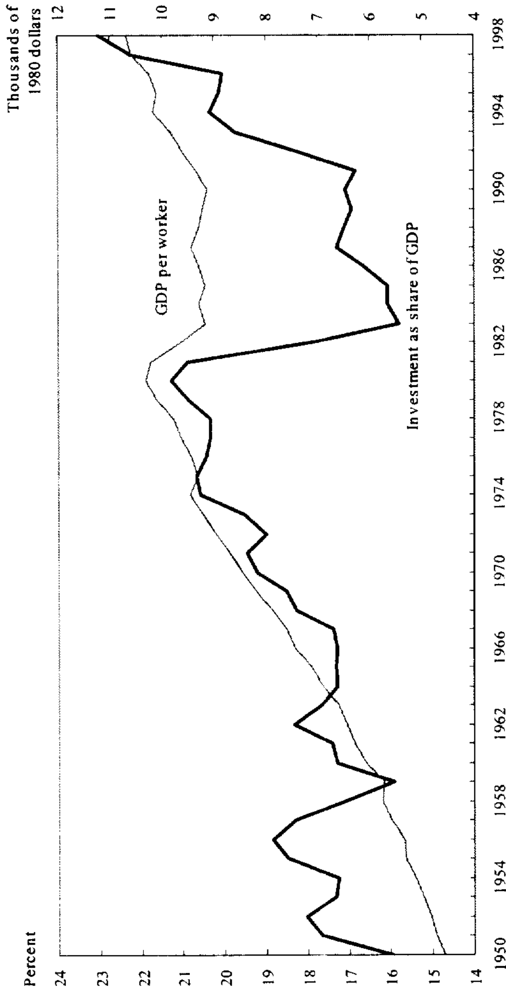
Reform advocates expected that opening Latin American economies to world markets and giving more rein to the private sector would increase investment and productivity, resulting in higher growth rates. In the process, a move toward tradables would occur, leading to a greater role for exports. To some extent this has occurred, but in an uneven way across countries and sectors.

Long-Term Trends

In most project countries, investment and labor productivity have recovered their previous levels after significant declines in the 1980s. As measured by simple averages, by 1998 both variables were back to or a little above their levels at the end of the import-substitution period (see figure 3).* These averages hide substantial differences across countries.

* Throughout the paper, simple averages are used to prevent the weight of Brazil and Mexico from overwhelming the other cases. Weighted averages would show that investment is still below the 1980s peak.

Figure 3. *Investment and Labor Productivity Trends, 1950–98*[a]



Source: Project database.

[a] Based on simple average for eight project countries (excluding Jamaica).

Bolivia, Chile, and Costa Rica were especially successful in raising their investment rates, while Argentina, Chile, and Colombia led in productivity growth. Mexico and Brazil lagged behind, however, such that weighted averages for the region have not yet returned to their 1980 levels.

In analyzing the impact of the reforms on investment performance, two questions are important to consider: are current investment rates sustainable, and are they sufficient? The issue of sustainability, in turn, involves two subpoints. First is whether investment rates will remain at their current levels or rise or fall in the coming years. As explained in the next section, the answer is that we still do not know, since the majority of the regional economies are still in a transitory phase.

Second, sustainability also depends on how investment is financed. Little external savings occurred in the 1980s; most investment had to be financed by national savings. In the 1990s, the return of foreign capital changed that pattern substantially. By 1998, external savings had risen to account for over 5 percent of GDP, compared to nearly 19 percent for national savings. The 5 percent for foreign savings, which is another way of expressing the current account deficit, is about the limit that investors seem willing to finance.

Whether investment has been sufficient depends in the first instance on the growth rate that is desired. Several years ago, ECLAC suggested that a 6 percent rate is needed to tackle the social issues pending in the region (poverty, unemployment, and others). There seemed to be substantial agreement around such a figure. Based on capital-output ratios for a number of countries, a necessary investment rate of 28 percent of GDP was hypothesized. This is nearly five points higher than

the simple average shown in figure 3, underlining the need for increased savings and investment.

Productivity trends are closely related to investment rates as can be seen in figure 3. Greater amounts of capital per worker should result in increased output per worker, but of course other factors are also relevant. These include the age, health, and education level of the labor force, management and organizational arrangements in the firm, technological advances, and public sector activities such as training and support for research and development. In the pre-reform period, many of these activities were coordinated by so-called national innovation systems in which governments played a leading role. Their privatized and internationalized replacements are still being tested in the post-reform period.

Post-Reform Investment Phases

Analyzing the reforms' impact on investment and productivity is a complex task because many things were happening simultaneously. In addition, the reforms themselves had different effects over time. The project studies of individual country experiences suggest the need to distinguish a transitional period from a consolidated one in order to understand the potential impact of the reforms. Given the timing of the initiation of the reforms, almost all of the project countries are still in the transition period. Extrapolating on the basis of what has occurred up till now could result in quite misleading conclusions.

The transition period, in turn, consists of a phase dominated by negative factors and another dominated by positive factors. The former was centered on the uncertainty generated by the reforms themselves, often compounded by macroeconomic disequilibria or problematic

international conditions. Faced with this uncertainty, investors reacted defensively, rationalizing production processes and introducing disembodied technical change to increase productivity. Investment in fixed capital was highly unusual under such circumstances. The positive transitory factors, involving one-time investments, began when some of the uncertainty was dissipated. Examples included investments to reduce costs, upgrade products for export, fulfill privatization obligations, or support the entry of transnational corporations into new markets. Only after these two phases ended would the transition be complete and investment determined by the "normal" factors that characterize all capitalist economies (macroeconomic stability, anticipated demand, relative prices, technological upgrading, and so on).

The case studies of the project countries found evidence to support the existence of the three phases. That is, immediately following the reforms, investment coefficients declined in most cases to levels not only below previous maximums but also previous minimums. Only in the second half of the 1990s did the coefficients tend to reach levels similar to those observed for the pre-reform period. Project results indicate that of the eight countries with investment data available, only Chile has reached the third phase when the reforms are consolidated; all others are still in the transitory phase. As a consequence, it is difficult to know what their investment rates will be once the temporary period ends.

Impact of Reforms

According to both econometric and qualitative evidence, the two reforms that were most important for determining investment patterns were import liberalization and privatization. Both appear to have had a positive

impact although with the delay that was just discussed. Import liberalization lowered costs for imported items, both inputs and capital goods, and increased competitive pressures, while privatization brought new actors, especially transnational corporations, to the region.

Reforms and Growth

While investment and productivity rates had returned to their pre-debt crisis levels by the end of the 1990s, the same was not true for GDP growth rates. Simple averages for the nine project countries show that growth rates fell from 5.3 percent to 4.0 percent between the 1950–80 base period and the 1990s. Weighted averages displayed a sharper difference, falling from 6.0 to 3.2 percent, respectively (see table 5).

These averages result from sharply different performances between two groups of countries. The four that grew most slowly in the base period (Argentina, Bolivia, Chile, and Peru) were the fastest growing in the 1990s. This group also grew substantially faster in the 1990s than in its own past (with the exception of Peru, which grew at about the same rate). On average among the four, growth in the base period was 4.0 percent, rising to 5.6 percent in the 1990s. The largest increase was found in Chile, where growth rates nearly doubled.

Table 5. *GDP Growth in Selected Periods, 1950–98*[a]

Percent

Country	*Base period(1950-80)*	*Crisis period*	*Post-crisis period*		
			Recovery	*Growth*	*1990s(1991–98)*
High growth					
Argentina	3.8	-1.1	10.1	4.5	5.8
Bolivia	3.5	-1.7	3.5	4.3	4.3
Chile	3.9	1.4	5.2	7.6	7.7
Peru	4.9	-1.2	5.1	4.2	4.6
Simple average	4.0	-0.7	6.0	5.2	5.6
Low growth					
Brazil	7.0	1.3	...	2.4	1.8
Colombia	5.1	2.8	...	3.8	3.6
Costa Rica	6.5	0.2	...	4.0	4.0
Jamaica	5.5	-1.2	....	2.1	0.2
Mexico	6.5	1.0	2.4	3.3	3.1
Simple average	6.1	0.8	...	3.1	2.5
Simple average, total	5.2	0.2	5.3	4.0	3.9
Weighted average, total	6.0	0.8	4.9	3.4	3.2

Source: Hofman (2000), on the basis of project data.

[a] Average annual compound growth rate.

The remaining five countries (Brazil, Colombia, Costa Rica, Jamaica, and Mexico) grew more slowly in the 1990s than in the base period and more slowly in the 1990s than did the other four countries. The simple average growth rate of the five in the base period was 6.1 percent, compared to 2.5 percent in the 1990s. The most dramatic declines in growth occurred in Brazil, Mexico, and Jamaica; since the first two are the largest countries in the region, this explains the difference between the simple and weighted averages shown in table 5.

Growth Accounting

A first approximation to explaining these trends can be found in a growth-accounting framework. Table 6 shows the trends with respect to factor accumulation for all countries except Jamaica. The group of eight countries as a whole increased labor input between the base period and the 1990s. Since hours worked fell in most countries, this increase implies a larger number of persons working. Capital accumulation, in contrast, fell sharply between the base period and the later years.

The two subgroups displayed diverging tendencies. For the group of faster-growing countries, the growth rate of labor input more than doubled, while in the slower-growing countries, the rate actually fell. Capital accumulation experienced a relatively small decline in the fast-growing countries; it was much more dramatic in the slow-growth group. Despite these different tendencies with respect to the past, however, the two groups had similar growth rates for both labor input and capital accumulation in the 1990s. This suggests that other variables must explain much of the difference in GDP growth rates between groups in the 1990s.

Indeed, it is with respect to productivity that we can begin to distinguish between the high- and low-growth countries in the 1990s rather than only with respect to their own past performance. Factor inputs grew at fairly similar rates in the 1990s when compared across the two groups; education levels were also nearly identical. But productivity trends for labor and capital increased at very different rates. Labor productivity among the faster-growing group rose by four times the rate found among the slower-growing set (2.9 percent in comparison to 0.7 percent). With respect to productivity of capital stock, the fast-growing countries had an average rate of increase of 1.6 percent, while the others fell slightly.

Table 6. *Factor Inputs to Growth, 1950–98*[a]

Percent

	Labor input (hours worked)	*Capital accumulation*		
	Base period(1950-80)	*1991–98*	*Base period(1950-80)*	*1991–98*
High growth				
Argentina	1.2	11.5rtt	4.9	2.5
Bolivia	1.0	3.5	2.8	3.3
Chile	0.4	2.8	4.2	6.8
Peru	2.0	3.0	5.0	2.9
Simple average	1.2	2.7	4.2	3.9
Low growth				
Brazil	2.9	1.4	9.8	2.6
Colombia	2.3	2.0	4.1	3.8
Costa Rica	2.9	3.1	7.2	4.6
Mexico	2.6	3.1	7.7	2.4
Simple average	2.7	2.4	7.2	3.4
Simple average, total	1.9	2.6	5.7	3.6

Source: Hofman (2000), on the basis of project data.

[a] Average annual compound growth rate.

These results are reflected in the data for total factor productivity, which report productivity of all factors combined as well as other residual elements not captured in the analysis. Table 7 shows data for two measures: total factor productivity and doubly-augmented total factor productivity. The latter takes into account quality improvements in both labor and capital as well as their quantitative changes. Not surprisingly, we find the same pattern as for labor and capital productivity. The fast-growing countries (with the exception of Bolivia) increased their productivity between the base period and the 1990s. The slower-growing

countries, in contrast, saw the basic measure decline. Insofar as productivity is a crucial determinant of a country's ability to compete in the world economy, this would suggest that the group of countries that grew fastest in the 1990s—largely on the basis of higher productivity—will enjoy additional advantages in the future. *(see table7)*

Table 7. *Growth of Total Factor Productivity, 1950–98*[a]

Percent

Country	*Total factor productivity*		*Doubly-augmented Total factor productivity*	
	Base period (1950-80)	*1991–98*	*Base period (1950-80)*	*1991–98*
High Growth				
Argentina	1.5	4.0	0.6	3.2
Bolivia	2.0	1.2	0.9	0.0
Chile	2.0	3.9	1.2	2.8
Peru	1.9	2.0	0.9	1.5
Simple average	1.9	2.8	0.9	1.9
Low Growth				
Brazil	2.6	0.1	1.4	-0.7
Colombia	2.4	1.1	1.4	-0.3
Costa Rica	2.2	0.7	1.2	-0.3
Mexico	1.8	0.7	0.5	-0.3
Simple average	2.3	0.7	1.1	-0.4
Simple average, total	.1	1.7	1.0	0.7

Source: Hofman (2000), on the basis of project data.

[a] Average annual compound growth rate.

The Impact of Reforms on Growth

Econometric evidence indicates that, as was the case with investment, the reforms had a positive impact on growth, although the coefficients suggest the impact was small. In particular, import liberalization, privatization, and capital account opening were positively and significantly correlated with higher growth rates. These positive effects

increased over time, with stronger results for three and five-year averages of the reform variables than for contemporaneous values.

With respect to individual country performance, it will be noted that the four countries identified as aggressive reformers were the same ones that grew most rapidly in the 1990s; the cautious reformers grew more slowly (see tables 2 and 5). On the surface, this relation appears to provide evidence that more reforms lead to higher growth, but the situation is actually much more complicated. The reforms worked together with macroeconomic and international trends. The elimination of hyperinflation, in particular, had a very positive impact on growth. In addition, the aggressive reformers chose to undertake many reforms in a very short time period because they were in such dire straits with respect to hyperinflation and negative growth in the preceding years; their economies were also much more distorted than others and this was often accompanied by problems of governability. Not surprisingly, the change in policy orientation led to new investment and an acceleration of growth rates, after a period in which economic actors waited to see if the new policies would be continued.

Initially, of course, this expansion was only recovery from the previous recession, but it eventually became growth per se. One of the mechanisms bringing about the increase in growth had to do with potential investments (and therefore productivity increases) that were not undertaken in those countries with poor initial conditions. Once the changes were carried out, and assuming the other factors were also favorable, the potential for high growth rates was present for some period of time.

The group of countries that had been doing reasonably well in the pre-reform period had less reason to undertake major structural changes in their economies. Although they did implement gradual and selective

reforms, they got a smaller boost from them because of the lack of a reservoir of unexploited opportunities. These countries also encountered serious macroeconomic problems that had a negative effect on growth rates. Mexico and Brazil already had high inflation rates at the beginning of the reform period. The type of stabilization policies they followed, which relied on an overvalued exchange rate, eventually resulted in foreign exchange crises. Colombia, Costa Rica, and Jamaica also began to suffer macroeconomic disequilibria during the 1990s.

Reforms and Employment

The reforms were expected to have a positive impact on employment through both faster growth of output and a shift toward more labor-intensive production technologies. Moreover, the anticipated higher demand for unskilled labor was projected to lower the skill premium and improve income distribution. None of these things occurred.

Long-Term Trends

Experts agree that long-term trends in employment are determined by changes in the labor supply. Nonetheless, other factors, including the impact of the reforms, can be important in the short and medium run. To minimize the problems caused by the strong correlation between labor supply and total employment, we concentrated on trends among wage earners, a category more closely related to labor demand.

Table 8. *Employment Growth and Elasticities, 1950s to 1990s*[a]

Annual weighted average

Period	*GDP growth*	*Growth of employment*	*Employment elasticity re: output*	*Growth of wage employment*	*Wage employment elasticity re: output*
1950s	5.1	1.9	0.4	2.5	0.5
1960s	5.7	2.3	0.4	2.7	0.5
1970s	5.6	3.8	0.7	4.7	0.8
1980s	1.2	2.9	2.6	2.4	2.0
1990–97	3.7	2.2	0.6	2.2	0.6
Average	4.3	2.6	0.9	2.9	0.9

Source: Weller (2000), on the basis of official statistics.

[a] For the 1950s to 1970s, employment growth corresponds to growth of the labor force. From the 1950s through the 1980s, 20 countries are included; for 1990–97, the number is 17.

Based on this distinction, Table 8 shows economic growth by decade in the postwar period, creation of total and wage employment, and the respective elasticities. Leaving aside the 1980s, which were clearly atypical, elasticities did not differ significantly in the 1990s from the 1950–80 base period. Insofar as the 1990s reflected the impact of the reforms, it can be inferred that the reforms did not affect—either positively or negatively—the long-term relation between GDP growth and employment creation. Rather, what stands out in the 1990s are lower growth rates, which led to more sluggish employment creation, especially for wage earners.

Problems in the 1990s

The slow growth of jobs during the 1990s was accompanied by increasing problems in job quality. To use the terminology popularized by the International Labour Organization (ILO), there was a shift from the formal to the informal sector, where the latter is defined as low-productivity jobs with workers receiving low wages and lacking access to benefits. In practice, the informal sector is measured by combining jobs in microenterprises, the self-employed, and domestic service. On this basis, according to the ILO, nearly 60 percent of new jobs in the project countries with information available were in the informal sector. They were especially prevalent in Brazil, where formal sector jobs fell in absolute terms, and in Colombia. Informal jobs were least important in Argentina and Chile.

A consequence of slow employment growth was the increase in the jobless rate during the 1990s. While unemployment on average during the decade fell slightly in comparison with the 1980s, it remained at levels that were very high for the region. Moreover, the rate rose throughout the 1990s, with an average for project countries in 1998 of nearly 9 percent. Theory would tell us to expect an inverse relationship between unemployment and wage trends, but this did not appear to hold in this particular period. Real wages increased or at least held their own in almost all cases during the 1990s. In Argentina, the elimination of inflation was accompanied by nearly constant real wages; only Chile had continuous increases throughout the decade.

Table 9. *Changes in Labor Market Indicators, 1990s*[a]

Country	*Occupation level*[b]	*Unemployment*[c]	*Wage employment*[d]	*Real wage*[e]	*Labor productivity*[f]
Argentina	-	-	+	=	+
Bolivia	+	+	-	+	-
Brazil	-	-	=	+	+
Chile	+	+	+	+	+
Colombia	=	-	-	+	+
Costa Rica	+	=	=	+	+
Jamaica	-	=	+	+	-
Mexico	+	-	+	+	=
Peru	+	-	-	+	+

Source: Weller (2000), based on consultant reports.

[a] The evaluation refers to changes between the beginning of the 1990s and 1998 (Bolivia and Peru: 1997).

+ means a favorable change; - means an unfavorable change; = means very little or no change.

[b] Percent change in the rate of employment.

[c] Percent change in unemployment rate.

[d] Growth of wage employment with respect to total employment.

[e] Percent change in real average wages in the formal sector.

[f] Percent change in average labor productivity

Table 9 provides a simple qualitative summary of various changes: the employment rate, unemployment, wage employment compared to total employment, real wages, and labor productivity. The table assigns a plus where conditions improved, a minus where they deteriorated, and a zero where they remained relatively constant, which enables us to compare across issue areas and across countries. The most positive trends occurred with respect to real wages, which were often linked to productivity rises. Rising unemployment appears to be the biggest problem; it was also frequently related to productivity but in an inverse direction. Changes in the level and type of employment (wage earners as

a share of total new jobs) occupy intermediate positions in the nine countries.

The Impact of Reforms on Employment

How do the overall trends among labor variables and the specific differences among countries relate to the reforms? Up till now, we have been examining trends in the 1990s as a proxy for the post-reform period, but econometric evidence from the project provides a more direct link. A first conclusion is that expansion of output is closely related to the generation of employment. This reinforces the idea that the weak growth rates of the 1990s—in comparison to the earlier years of the postwar period, not to the 1980s—caused a good part of the employment problem. The stop-go pattern that characterized growth in the 1990s further restrained job creation.

A second conclusion is that the reforms themselves hindered the growth of employment. The negative coefficients were significant for the average reform index as well as for the trade reform and capital account indexes. It also holds for both the contemporaneous values of the reforms and three-year averages. Of course, in so far as the reforms increased growth, this partially offset the negative impact, but the direct effect was clearly negative.

Wage Differentials

A key link between the labor market and income distribution is the wage differential. Abundant evidence suggests that this differential increased in the 1990s in comparison with the previous decade; our findings corroborate such a trend. Table 10 shows two versions of an education-

based wage gap; both show an increase in almost all countries studied. The main exception was Costa Rica. Using slightly different definitions and periods, another of our studies produced similar results, although it also found a decline in the wage gap in Chile. Data on wage differences between white-collar and blue-collar workers lead to similar conclusions with respect to an increasing wage gap.

These measures point to a widening gap in wages based on skill level, which is the opposite of what proponents of the reforms expected. Theoretical analysis would point to relative prices favoring cheaper capital over more expensive labor as the main cause of the phenomenon. The change in relative prices would lead to a substitution of labor by capital and thus a higher capital-labor ratio. According to data gathered for the project, however, relative price trends did not manifest themselves in any consistent pattern with respect to the capital-labor ratio. The ratio rose in Brazil, Chile, Costa Rica, and Mexico in the 1990s, fell in Argentina, Bolivia, and Peru, and remained about the same in Colombia and Jamaica.

If relative prices do not explain the widening wage gap, one alternative is firm restructuring that was not associated with skilled labor as a complement to capital. For example, restructuring that involved increased use of outsourcing for services could lead to the employment of more skilled workers in the tertiary sector and fewer unskilled workers within the firm itself. The operation of the labor market provides another explanation: the declining strength of unions probably played a role in some countries, since less-skilled workers were less likely to be represented by labor unions, as did policy with respect to the minimum wage, which has frequently been allowed to lag with respect to the average wage.

Table 10. *Wage Differentials by Education Level, 1990s*[a]

Percent

Country (period)	*University graduates vs. Average wage*		*University graduates vs. 7-9 years of education*	
	Initial year[b]	*Final year*[c]	*Initial year*[b]	*Final year*[c]
Argentina (1991–97)	164.3	169.6	218.3	227.9
Bolivia (1989–96)	235.0	292.9	251.8	506.4
Brazil (1992–97)	380.2	383.5	553.2	553.3
Chile (1990–96)	231.6	247.9	366.1	448.6
Colombia (1988–95)	222.2	261.6	276.7	327.2
Costa Rica (1990–96)	285.0	273.2	323.1	316.7
Mexico (1991–97)	182.1	232.1	160.1	302.2
Peru (1991–97)	220.7	275.0	321.0	403.1
Simple average	240.1	267.0	308.8	385.7

Source: Weller (2000), on the basis of consultant reports.

[a] Ratio of average wages of specified groups.

[b] Initial year of period indicated for each country.

[c] Final year of period indicated for each country.

Patterns of Income Distribution

The distribution of income that is most closely linked to outcomes from the labor market is the primary distribution, which measures income accruing to the factors of production (mainly labor in our data). This distribution, in which the unit of analysis is the individual, differs from the household-based measures that are most commonly cited, and the trends may be different. The primary distribution is the most relevant, however, insofar as we are trying to understand the impact of the reforms

on distribution, and the operation of the labor market is a key intervening factor. Note that it does not incorporate the role of unemployment since it includes only those individuals with "earned" income.

Table 11. *Primary and Household Distribution of Income, 1980s to 1990s*

Country	*Pre-reform*	*Post-reform*	*Latest*
Primary distribution[a]			
Argentina[b]	.293 (1986)	.268 (1991)	.283 (1996)
Bolivia[b]	.668 (1985)	.486 (1989)	.595 (1996)
Brazil	.680 (1985)	.700 (1990)	.710 (1997)
Chile	n.a.	.658 (1987)	.636 (1996)
Colombia[b]	.582 (1988)	.596 (1993)	.625 (1996)
Costa Rica	n.a.	.490 (1988)	.478 (1995)
Jamaica	n.a.	n.a.	n.a.
Mexico	.200 (1984)	.270 (1989)	.290 (1996)
Peru	.579 (1985)	.502 (1991)	.485 (1996)
Household distribution[c]			
Argentina[b]	.407 (1986)	.461 (1991)	.486 (1996)
Bolivia[b]	.590 (1985)	.430 (1989)	.480 (1996)
Brazil	.590 (1985)	.610 (1990)	.590 (1997)
Chile	n.a.	.560 (1987)	.553 (1996)
Colombia	.516 (1978)	.531 (1991)	.533 (1995)
Costa Rica	.415 (1986)	.361 (1988)	.376 (1995)
Jamaica[d]	.436 (1989)	.382 (1993)	.369 (1996)
Mexico	.474 (1984)	.537 (1989)	.540 (1994)
Peru	.519 (1985)	.467 (1991)	.435 (1996)

Source: Morley (2000), on the basis of consultant reports.

[a] Theil index. Wide differences in the size of the index for primary distribution owes to the particular subgroup of the population that was analyzed.

[b] Urban only.

[c] Gini coefficient.

[d] Expenditure rather than income data.

Table 11 shows both primary and household distributions for project countries. The data come from the household surveys, which provide a great deal of information on certain types of income. Nonetheless, they

have two major flaws in terms of studying the impact of the reforms on distribution. First, they do not necessarily include all types of income; for example, profits are frequently excluded. Second, they do not sample the wealthiest groups in society, which we have reason to believe were primary beneficiaries of the reforms. Thus, the analysis below probably underestimates the impact of the reforms in increasing inequality.

Primary Income Distribution Trends

We were able to study the primary distribution in only eight of the nine project countries; data are not available for Jamaica. Three patterns can be distinguished among the cases. A first involves declining inequality in Chile, Costa Rica, and Peru. Pre-reform measures were not available for Chile or Costa Rica, but comparing the early post-reform years with the latest available observation shows that inequality decreased slightly. A second pattern is found in Brazil, Colombia, and Mexico, where inequality increased from the pre-reform period to the latest year. Again, none of the changes was very large. Finally, Argentina and Bolivia followed a mixed pattern with a decline in inequality between the pre-reform and early post-reform period, after which inequality began to rise again. It is important to stress that these results pertain only to reforms in the 1980s and 1990s. Both Chile and Argentina suffered significant increases in inequality during their reform experiences in the 1970s, although it is hard to determine whether this arose because of the reforms per se or the repressive policies of the military governments.

Data on household distribution for all nine project countries are also shown in table 11. In the majority of the cases, the trends are similar to those for primary distribution. The most important exception is the continuing increase in inequality in Argentina in the household data. This

difference is likely due to the fact that the household data capture the impact of unemployment, which was rising rapidly in Argentina. For household distribution, data are available for Jamaica; they show falling inequality over the period.

The trends in primary distribution correlate with trends in the wage gap. The wage gap shrank in Chile and Costa Rica, and income distribution improved. Likewise, the gap widened in Brazil, Colombia, and Mexico, and income distribution became more unequal. The situation is more complicated for Argentina, Bolivia, and Peru. These countries experienced very high inflation around the time the reforms were implemented. Since lowering high inflation has a positive impact on distribution, because inflation levies a heavy tax on the poorest groups in society, it is likely that this factor was at least partially responsible for the U-shaped trends. After a one-time improvement, inequality began to increase again in Argentina and Bolivia, in line with the skill gap. Peru presents a special case in that the wage gap increased substantially, but the index suggests that inequality fell slightly. This seemingly greater equality was really less dispersion around a declining average income in the 1985–90 period; that is, everyone was getting poorer. In the 1990s, per capita income growth was positive although poverty continued to rise. (The situation in Jamaica was similar.)

The Impact of Reforms on Household Distribution

The more extensive data that exist on household distribution enable us to move beyond before-and-after analysis and to estimate directly the impact of the reforms on equity. To do so, a regression model was constructed for the nine project countries (plus seven others) for the period 1970–95. In contrast to almost all other studies, this study finds

evidence of the existence of a so-called Kuznets curve. This is the inverted U-shaped curve where distribution becomes more unequal on the way up the income curve, while beyond an inflection point, inequality falls.

With respect to the impact of the reforms on the level of the Gini coefficient, the equations indicate that the overall reform variable had a small, but negative, effect on distribution. This confirms the qualitative, case-study evidence from other sources. The individual indexes showed a more complicated pattern. To increase the number of observations, urban and national samples were both used. Considering the two separately and together gave three samples with quite different results for the individual reforms. That is, at least some of the individual reforms appear to have behaved differently in urban and rural settings.

Table 12. *Impact of Individual Reform Indexes on Household Income Distribution*

Type of reform	*Combined sample*	*Urban Sample*	*National sample*
Import liberalization	Regressive	Regressive	Regressive*
Capital account opening	Progressive	Progressive *	Progressive*
Tax reform	Regressive*	Regressive	Regressive*
Domestic financial liberalization	Progressive*	Regressive*	Regressive
Privatization	Regressive*	Progressive	Regressive

Source: Morley (2000).

* Significant at 1 percent level.

Table 12 summarizes the outcomes. Three of the reforms provide consistent results across the three samples: trade liberalization and tax reform were always regressive, and capital account opening was always progressive. In some cases, the coefficients were statistically significant, while in other cases they were not. Domestic financial reform and

privatization appear regressive in two of the three samples, but each is progressive in one sample, suggesting that we really do not know enough about these two reforms to make a judgment.

Social Expenditure and Equity

Government social expenditure, which increased in the 1990s in comparison with the previous decade, helped to lower the very high levels of inequality in the region. The principal instrument was the provision of so-called basic social services, especially primary education and health; a high proportion of these services go to poor families. The benefits from social security and university education, in contrast, go mainly to middle-income groups.

Table 13. *Impact of Social Expenditure on Income Distribution, 1990s*

Country (year)	*Top quintile income/lowest quintile income*		*Increase in the income of the lowest quintile (percent)*
	Excluding social expenditure	*Including social expenditure*	
Argentina (1998)	14.2	6.1	142.2
Brazil (1994)	24.6	12.6	97.6
Chile (1996)	14.8	8.9	68.0
Colombia (1992)	11.0	7.9	41.2
Simple average	16.2	8.9	87.3

Source: Mostajo (2000), on the basis of country studies.

As table 13 shows for four of the project countries, expenditure on basic social services significantly increased household incomes of the lowest quintiles. The effect on incomes ranged from 41 percent in Colombia to 142 percent in Argentina, with an average of 87 percent. In

other words, calculating the monetary equivalent of the benefits provided through the social programs and adding them to the autonomous income of the households had a significant impact on the welfare of the poorest 20 percent of the population. For example, social benefits accounted for 31 percent of total consumption of this quintile in Colombia and 54 percent in Argentina.

Social expenditure also had a positive impact on income distribution, reducing the gap between the income of the highest and lowest income quintiles. Without social expenditure, the income of the highest quintile on average among the four countries would have been sixteen times higher than that of the lowest quintile; with social expenditure the ratio fell to nine. Despite this improvement in distribution, it should be noted that even including social expenditure, regional concentration of income remains well above that of most low- and middle-income countries in Europe and Asia before taking account of social expenditure.

Heterogeneity in the Responses of Sectors and Firms

The sectoral and microeconomic analyses provide an essential complement to the aggregate results on growth and employment. Although the reforms did not aim at promoting specific sectors or firms, neither were they meant to be neutral. At the sectoral level, expectations focused on increasing the share of exports in total output. Trade liberalization and the phasing out of industrial and agricultural policies would lead a country to specialize in areas in which it had comparative advantages. As the proponents of the reforms assumed that Latin America's advantage lay in unskilled labor, they expected that labor-intensive sectors would produce the most dynamic export performance and that labor-intensive small firms would grow faster than larger ones.

At the most general level, structural change in Latin American production was moderate after the reforms. The tradables sectors continued the long-term trend of reducing their share in output. Behind these aggregate figures, however, we found substantial impacts of the reforms, as well as increasing heterogeneity, across sectors and types of firms. Trade liberalization led to two different patterns of export growth in the 1990s: integration into the North American market through manufactured exports in Mexico, Central America, and the Caribbean versus a concentration in natural resource–based commodities in South America. The difference was due to trade arrangements such as North America Free Trade Agreement and the Caribbean Basin Initiative, which fostered manufacturing exports, particularly by the *maquila* plants.

Investment and Productivity Dynamics: Increasing Specialization

Investment in the post-reform period was concentrated in a relatively small number of sectors. Only one sector (tele-communications) saw dynamic investment in all countries, and only one country (Chile) increased investment in all major sectors (see table 14). Manufacturing investment was particularly dynamic in some capital-intensive subsectors (for example, cement, steel, petrochemicals, and chemicals). Nonetheless, investment co-efficients overall were, at best, slightly higher than in the pre-reform period.

Privatization was instrumental to investment recovery and to modernization when other necessary conditions were also present. It fostered investment in certain tradables (for example, mining and natural gas), although linkages with the rest of the economy continued to be weak. In nontradables, the biggest increases in investment were in telecommunications; results were mixed in electricity and transportation.

Privatization alone did not guarantee efficient performance. Strengthening property rights proved to be an important factor for attracting foreign investment in mining, while increased competitive pressures were necessary to ensure efficient market outcomes in the services sectors, like telecommunications.

Table 14. *Dynamism of Sectoral Investment after the Reforms*[a]

Country	*Mining*	*Oil and gas*	*Manufacturing*	*Telecommunications*	*Electricity*	*Transportation*
Argentina	Medium	High	Medium	High	Medium	Medium
Bolivia	High	High	Low	High	Medium	n.a.
Brazil	Low	Low	Medium	High	Low	Low
Chile	High	Medium	High	High	High	High
Colombia	n.a.	High	Medium	High	Medium	Low
Costa Rica	n.a.	n.a.	High	High	High	High
Mexico	n.a.	Medium	Medium	High	Medium	High
Peru	Medium	Low	Low	High	Medium	High

Source: Moguillansky and Bielschowsky (2000), on the basis of the project sectoral studies.

[a] High (low) dynamism implies that the investment-to-GDP coefficients were bigger (smaller) after the reforms than in the pre-reform period, except for Argentina and Chile, for which the base period is the early 1990s and early 1980s respectively. When coefficients are not significantly different between periods, dynamism is qualified as medium.

Large firms were the most dynamic investors, although smaller companies had a minor presence in some activities where investment grew rapidly. Among big firms, transnational corporation subsidiaries gained ground vis-à-vis large domestic conglomerates. These subsidiaries were responsible for much of the investment growth, not only in the most dynamic areas of manufacturing, but also in mining and telecommunications. Privatizations, liberalization of regulations that prevented foreign firms from investing in many sectors, and the

globalization of important industries combined to strengthen the position of foreign corporations. Nonetheless, the large firms contributed relatively little to the generation of employment since they tended to be more capital-intensive.

Productivity gains were more evenly spread across broad sectors (agriculture, manufacturing, and services), but heterogeneity increased within subsectors, for example, between commercial and family agriculture. Likewise, within manufacturing, some subsectors performed very well but others lagged behind. Despite productivity growth, the productivity gap for manufacturing as a whole vis-à-vis the United States did not narrow in the 1990s (see table 15). Specific subsectors in which investment was dynamic showed a sharp increase in productivity and did narrow the gap. This was partly a continuation of adjustment processes begun during or even before the crisis of the 1980s. Although the gap between the productivity of large firms and that of small and medium-size enterprises narrowed in some countries, performance continued to be extremely dissimilar. Modernization processes, like investment, occurred mainly among larger firms.

Table 15. *Labor Productivity in Manufacturing with Respect to the United States, 1970–96*

Country	*1970*	*1980*	*1990*	*1996*
Argentina	0.42	0.41	0.55	0.67
Brazil	0.28	0.26	0.29	0.37
Chile	0.25	0.24	0.23	0.20[a]
Colombia	0.29	0.25	0.37	0.34
Costa Rica	n.a.	n.a.	0.15	0.14[b]
Jamaica	0.26	0.16	0.16	0.13[b]
Mexico	0.32	0.30	0.44	0.38[c]
Peru	0.33	0.25	0.16	0.15

Source: Katz (2000), using ECLAC's PADI database.

[a] Information for 1995.

[b] Information for 1992.

[c] Information for 1994.

The importance of external factors in the incorporation of new technologies increased in tandem with the investment process. The growing significance of imported capital goods, the substitution of foreign for domestic inputs, and the construction of technologically advanced plants by foreign firms all resulted in a greater presence of foreign components in the region's sectoral innovation systems. At the same time, the state reduced its involvement in technological efforts, but private actors have not always stepped in to fill the void.

Trade liberalization and privatization were the reforms that had the greatest impact at the sectoral and microeconomic levels. Trade liberalization put pressure on firms to increase competitiveness by substituting imported for national inputs. It also facilitated subregional integration processes that opened markets for manufacturing exports. Privatization, meanwhile, was instrumental in stimulating investment and modernization, especially when it coincided with growth in international demand or took place in activities experiencing accelerated technological change.

Despite these positive developments, important problems can be identified at the sectoral level: growing manufacturing trade deficits; the enclave nature of large mining firms; uncertainty about future investments in the electricity sector once the installed capacity is fully utilized and service tariffs are set under market conditions; and poor regulation plus high barriers to entry for new competition in both electricity and telecommunications. In addition, the reforms did not solve, and quite probably increased, two broader problems: investment continued to be concentrated among large enterprises that have not shown the capacity to develop backward and forward linkages with smaller firms, and supplier chains were destroyed by the quest for competitiveness through increasing imported inputs. Both processes led

to specialization and higher efficiency, but they also led to polarization among actors and the persistence of the external constraint on growth.

Increasing Heterogeneity in Sectoral Employment

The reforms also failed to deliver the expected employment growth in the tradables sectors. Employment generation was jointly determined by secular trends and the impact of the reforms. Agriculture continued its long-term decline in total employment, and manufacturing generally lost share, except for the *maquila*. In manufacturing, most new jobs were created by small firms and microenterprises. These were the only firms that increased employment in countries like Argentina, Brazil, Chile, and Costa Rica, where they accounted for more that 100 percent of the net job creation, because larger firms posted a net job loss as a result of the downsizing that accompanied modernization (see table 16).

Commercial agriculture and formal sector manufacturing firms underwent an important process of modernization, which implied a more intensive use of capital. This negatively affected job creation in those sectors where output grew most strongly, such as natural resource–based commodities and the automobile industry. Changes also occurred across sectors, as well as within sectors. Specifically, activities that have traditionally produced the largest volume of employment, such as textiles and garments, declined across the board. Only the *maquila* assembly plants, operating under conditions that differ from those of the rest of the economy, provided the strong growth in highly labor-intensive activities that the reforms were expected to produce.

Table 16. *Contribution to Total Manufacturing Employment by Size of Firm, 1990s*

Percent

Country (period)	*Wage earners*					
	Micro enterprises	*Small enterprises*	*Medium-size and large enterprises*	*Unspecified*	*Other*	*Total*
Argentina (1991–97)	1.1	8.1	-11.6	-71.4	-26.2	–100.0
Bolivia (1989–96)	11.6	13.8	9.6	n.a.	65.0	100.0
Brazil (1993–96)	106.1	53.6	–265.0	–17.7	23.1	–100.0
Chile (1990–96)	27.6	122.8	–67.8	1.1	16.3	100.0
Costa Rica (1990–96)	118.0	42.8	–34.4	34.9	-61.3	100.0
Mexico (1991–97)	26.4	6.7	42.2	–3.7	28.4	100.0

Source: Weller (2000), on the basis of household surveys.

Note: The definition of groups of enterprises varies by country. Microenterprises always contain up to 5 workers. Small enterprises contain 6 to 9 in Costa Rica, 10 or under in Brazil, 49 or under in Chile, and 50 or under in Argentina, Mexico, and Peru.

Slow growth in labor-intensive tradables had a number of causes. First, the contradiction between the reforms, which sought to move toward an export-led growth model, and macroeconomic policies, which led to overvalued exchange rates, sent producers ambiguous signals that hindered investment in tradables. Second, assumptions made about the region's comparative advantage were wrong, at least for the level of generalization to which they applied. The regional experience and international comparisons have shown that the main advantage of Latin America in general, and of the South American countries in particular, lies in natural resources rather than in unskilled labor. This factor was compounded by changes in the relative prices of factors of production,

which occurred when trade liberalization sharply reduced the cost of capital goods.

Table 17. *Employment Growth by Sector, 1990–97*[a]

Percent

Sector	*Employment growth*	*Contribution to total*
Agriculture	-0.9	-11.1
Manufacturing industry	1.2	9.0
Construction	2.8	8.4
Commerce, restaurants, and hotels	3.5	30.9
Electricity, gas and water, transportation, storage, and communications	4.9	12.0
Financial services, insurance, real estate, and business services	6.8	14.0
Social, communal, and personal services	2.8	40.3
Other	-3.2	-3.5
Total	2.0	100.0

Source: Weller (2000), on the basis of official country statistics.

[a] Weighted averages for the nine project countries.

When the concentration of growth in capital-intensive activities created few jobs, services became the residual source of employment. Services had a heterogeneous performance: high-quality jobs were created in telecommunications, banking, and finance, but the bulk was in low-skill services (see table 17). In the services, polarization increased between activities that had been rapidly modernized and traditional ones that employed a low-skill workforce. The residual labor tended to be employed by the latter, leading to slow growth in the overall productivity of the sector. Microenterprises offered the greatest number of jobs, with most of them operating on an informal basis. The low rate of job creation by large, modern firms that offered higher wages led to a widening wage gap. Poor employment performance in the tradables sectors has thus been

accompanied by increasing heterogeneity and polarization in the labor market.

A Policy Agenda for the Next Decade

The ten to fifteen years of reforms in the region have led to significant accomplishments, but much remains to be done and many problems still exist. One influential set of proposals recommends further reforms; it calls for a deepening of first generation reforms complemented by a second generation of reforms, particularly in the field of education and state reform. Our view is that the vast majority of benefits that can be obtained from first generation reforms have already materialized. We agree with the growing consensus that another generation of reforms is needed, but our agenda is broader than that of most others.

Policies to Increase Growth

The Latin American and Caribbean economies need to grow faster and increase their competitiveness to improve their integration into the world market through higher value added exports. The two tasks are closely related: the core of a policy to achieve faster growth is to create better conditions for increasing productivity and investment. While most analysts agree with these objectives, they differ on the means to achieve them. Many would say that markets can handle these issues by themselves. In particular, they would argue that the reforms have strengthened competition in the countries of the region, having thus already generated the necessary incentive for higher productivity and more investment. We disagree because we do not believe that markets operate perfectly, always producing the most efficient outcome.

Concentrated markets do not necessarily lead to inefficient outcomes, when businesses operate under the pressure of strong rivalry among domestic firms or external competition. Competition, however, cannot be taken for granted. Even in tradables, unfair practices may arise. Competition policies should be aimed at preventing or eliminating such practices. In sectors where competition cannot work (for example, natural monopolies), regulation is the answer.

Major factor markets (technology, skilled labor, and capital) usually operate quite inefficiently. Policy proposals in these areas have long formed part of the academic and policymaking debate in the region. Smaller firms need special support to be able to access factor markets. While the costs of the using the market are relevant for all kinds of firms, they are particularly burdensome in relative terms for the smallest companies. The reduction of costs for small firms is most efficient when these firms are clustered in particular regions or sectors. Interaction, either through subcontracting between large and small firms or horizontal linkages among small firms themselves, can provide the basis not only for accessing factor markets but also for jointly developing new activities and markets.

Suggestions for reducing costs and increasing competitiveness would have a positive impact on existing production capacity, but additional investment is necessary to develop new capacity. Moreover, the region also needs more efficient allocation of investment. The reforms have corrected many of the distortions that led to inefficient investment, but they did not generate all of the incentives necessary to achieve faster capital accumulation.

Investment depends on expected rates of return, which can be affected through prices, costs, and the management of uncertainty. Since little can be done regarding prices, we focus on the other two elements. Progress in

correcting market failures to increase competitiveness will benefit the investment process through lower costs for technology. Further reduction of costs could be obtained through generalized tax reductions, but such an alternative would run counter to the need for greater social spending. Although it is impossible to eliminate the uncertainty inherent in market economies, it is possible to reduce the uncertainty caused by pendular swings in policy and unexpected policy shifts.

Reduction of costs and uncertainty will benefit investment irrespective of its origin, but a particular way of stimulating investment is to design policies to attract foreign direct investment and joint ventures between foreign and domestic firms. This was a major component of the first generation reforms, and one of the successes of those reforms was the dramatic increase of this type of investment in total capital inflows in the 1990s. The majority of that investment, however, went to purchase existing assets, either through privatization of public firms or takeovers of private corporations. What is needed in the coming years is to design policies to attract more greenfield investment, for which several international experiences provide useful lessons regarding both business facilitation measures and targeting.

A Social Offensive

Important problems remain with respect to growth, investment, and productivity, but progress has been made in these areas. Problems involving employment and equity, in contrast, have been exacerbated. The proposals for increasing competitiveness are likely to have a positive impact on employment and equity. Indeed, achieving high, stable growth rates is a necessary prerequisite for lowering unemployment and inequality, but growth alone is not enough.

Employment is the place to start. Even if investment grows rapidly in the region, our research has shown that likely investors would be large firms. With the exception of the *maquila*, these are not in labor-intensive activities. At the same time, the public sector, which traditionally provided a large number of high quality jobs in the region, is actually reducing its workforce. At this point in time in Latin America, most jobs in both urban and rural areas are in small firms and especially in microenterprises, so this group of firms merits special attention. Experiences with the *maquila* provide one source of lessons: reducing transaction costs and a more efficient supply of public goods and services have positive impacts on small production units.

An alternative suggestion on how to increase job opportunities is through flexibilization of the labor market more generally. Our view is that labor markets are already much more flexible than usually perceived. We are also concerned about jumping into drastic reform without adequate information on the likely consequences, with respect to both new jobs and the quality of existing jobs. A generic solution is particularly inappropriate given the extreme differences among labor markets in the region.

Policymakers would be better advised to think about ways to improve the functioning of labor markets rather than to concentrate exclusively on flexibilization. However, if a particular government decides that it wants to move forward on flexibilization per se, it would be essential to simultaneously guarantee access to unemployment insurance and to make benefits portable to smooth the transition between jobs. Clearly these measures will not eliminate structural unemployment, so they need to be combined with job creation policies as mentioned earlier.

The second element of the social offensive has to do with greater, more efficient social expenditure. A number of countries are close to the

maximum share of social spending in total public expenditure that is politically viable. This leaves three alternatives: more efficient use of existing resources, an increase in total public expenditure, which would require an increase in revenues, or greater participation by the private sector. All three have their problems; which alternative is more attractive would vary from country to country, depending on local circumstances and public preferences.

Improving and expanding access to education must receive priority among social services. Education expenditure has the double advantage of simultaneously contributing to competitiveness and greater equality, although this is a relatively long-run process. A large share of Latin America's distribution problems, as well as of its productivity problems, comes from its large stock of unskilled labor, which in turn derives from many years of inadequate education. This subject has been widely studied, but many controversies and implementation issues remain. How to improve quality is the main issue for primary education. At the secondary level, the issue is expansion of coverage and access, while at the university level, access and relevance of areas of specialization are paramount.

Increasing and improving social expenditure will not do much good if it is then cut when a crisis arises. This was the prevalent pattern in the 1980s, and since social expenditure is strongly procyclical, the threat of future cuts remains. Governments should make sure that social spending is protected when hard times come.

Macroeconomic Policy

It is essential to achieve greater competitiveness and social progress without undermining the macroeconomic stability that has been achieved

at great cost over the last decade. This is not just because macroeconomic stability has proved valuable for other reasons; without stability it is impossible to advance either in competitiveness or on social issues. The question is how to finance those elements of the two agendas that depend on the public sector. This requires a reassignment of resources in government budgets if no new resources are forthcoming.

The macroeconomic agenda can be divided into traditional and new topics. Traditional issues include fiscal, monetary, and exchange rate policies aimed primarily at stabilizing inflation. These have been remarkably successful over the last decade, although with variations across the region. The main trouble spot in the traditional macroeconomic area has to do with a resurgence of fiscal deficits. To some extent, this was the result of the cyclical downturn at the end of the decade, but the reforms themselves also contributed. One of the inconsistency syndromes suggested that the reforms conflicted with attempts at fiscal consolidation by cutting tax rates, lowering tariffs, and earmarking revenues for states and municipalities.

Two new topics are also on the agenda in the macroeconomic sphere. One has to do with growth and its finance; the other relates to the issue of volatility. Although the public sector has generally abandoned the role of producing goods (with the important exception of some key natural resource firms), it retains the function of providing an adequate context for growth. This involves not only stabilization, but also the promotion of savings and finance for growth. The government must make its own contribution to savings; hence the emphasis on fiscal consolidation. It must also seek policies to promote savings in the private sector. One policy that has become prominent among the project countries is the introduction of private pension schemes, but evidence suggests that this will increase savings only in the long run. ECLAC has made proposals

relating to the advantages of prior savings for home purchases and tax incentives to stimulate retained earnings. Nonetheless, higher growth rates themselves will continue to be the main determinant of higher savings.

Governments must seek ways to dampen imported volatility as well as that originating in the domestic economy. Policies that have proved helpful in some countries include commodity stabilization funds to mitigate cycles caused by terms-of-trade fluctuations and controls on short-term capital flows to limit the impact of swings in international finance. Adequate prudential regulation for the banking system is a complementary requirement to avoid the transmission of external volatility to the domestic financial system and thus to the rest of the domestic economy.

Public-Private Relations and International Economic Management

Two additional topics condition regional governments' ability to make progress on competitiveness and growth, the social offensive, and macroeconomic stability. These are the need to foster cooperation between the public and private sectors and to encourage more rational management of international economic relations.

The new economic model in Latin America and the Caribbean features a substantially stronger role for the private sector than was the case in the earlier postwar period. It is therefore essential for the government and private actors to work together more closely. What has still to be worked out is the nature of the relationship. Institution building through private-public partnerships is central to future progress. Latin America has made headway in this field, but achieving better results requires resources and consistency.

The dynamics of the international economy into which the region is increasingly integrated clearly affects the outcomes of the domestic economies. Governments need to develop policies to protect themselves from increased vulnerability without going back to the old closed economies. At the same time, seeking a greater voice in international negotiations toward the so-called new financial architecture is an important complement to domestic measures.

These proposals are not new. On the contrary, our aim was to combine into a coherent package a number of policy recommendations that have been under discussion for some time. Indeed, it would appear that a consensus is currently building in most governments of the region and the regional and multilateral institutions about the need to undertake such measures. A major stumbling block, however, is that the institutions responsible for implementing the policies are weak with respect to both human and financial resources. Overcoming widespread implementation failures must become the new priority if the countries are to reap the full benefits of the reforms and other measures already put into place. Only in this way can better performance be achieved and the benefits extended to the large majority of the population.

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