COMMENTS

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I want to talk today about how institutions and social policy relate to income inequality in Latin America and elsewhere in the developing world. I have three points.

- First, globalization, for all its benefits, also creates a risk of increasing inequality, as much or more in developing countries as in today's industrialized countries.

- Second, high inequality makes the design and implementation of good social policy difficult. Here Latin America has a special disadvantage: its historical legacy of already high inequality. Huge income disparities create economic, political and institutional barriers to broadening opportunities for the poor in the region.

- Thirdly, despite these two gloomy points, there are reasons to be optimistic.

Let me make two prefatory remarks. First, globalization – that is the trend of increasing integration of economies in terms not only of goods and services, but of ideas, information and technology – has tremendous potential benefits for developing countries. Nothing I say should suggest otherwise. The challenge is to realize the potential benefits without undertaking high offsetting costs. Second, not all inequality is a bad thing. Some inequality represents the healthy outcome of differences across individuals in ambition, motivation and willingness to work. This *constructive* inequality provides incentives for mobility and rewards high productivity. Some would say constructive inequality is the hallmark of the equal opportunity society the U.S. symbolizes. Increases in this constructive inequality may simply reflect faster growth in income for the rich than the poor – but with all sharing in some growth. But of course it can also be true that inequality is *destructive*, when for example it reflects deep and persistent differences across individuals or groups in access to the assets that generate income – including not only land (which

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is extremely unequally distributed in Latin America) but, so important in today's global information age, the asset of education. Destructive inequality undermines economic growth and efficiency, by reducing the incentives for individuals to work, to save, to innovate and to invest. And it often results in the perception if not the reality of injustice and unfairness – with the political risk in the short term of a backlash against the market reforms and market institutions that in fact are the critical ingredients of shared and sustainable growth.

Globalization and developing countries: the inequality risk

Both the market reforms associated with globalization, and the greater integration of global markets itself, can affect inequality in developing countries.

Market Reforms. Let us consider three major types of market reforms. First, trade liberalization. What is its implication for inequality? On the one hand, trade liberalization makes economies more competitive and thus is likely to reduce unequal rents to insiders. The end of import substitution programs and associated rationing of access to foreign exchange has probably been the greatest single factor in reducing the corrosive effects of corruption and rent seeking in Latin America. Trade liberalization can also generate new labor-intensive jobs in agriculture and manufacturing – raising the incomes for example of the rural poor. And trade liberalization implies cheaper imports, reducing the real costs of consumption for the urban poor – who after all unlike the rich use most of their income for consumption.

On the other hand, recent evidence shows that trade liberalization leads to growing wage gaps between the educated and uneducated, not only in the OECD countries but in the developing countries. Between 1991 and 1995 wage gaps increased for six of seven countries of Latin America for which we have good wage data. The exception is Costa Rica, where education levels are relatively high. Apparently the combination of technology change with the globalization of markets is raising the demand for and the wage premium to skilled labor faster than the educational system is supplying skilled and trainable workers. In Latin America education levels have been increasing, but painfully slowly – with for example only 1.5 years of additional education added to the average education of the labor force in three decades (in contrast to twice that

increase in Southeast Asia). And the distribution of education, though improving slowly, is still highly unequal, meaning that many of today's workers have even less than the current average of about 4.8 years of completed schooling.

In short, the effect of trade liberalization on inequality depends – including on the extent to which a country's comparative advantage lies in job-using agriculture or manufactured exports and on the extent to which education has been increasing and is already broadly shared. In Costa Rica, with good education and a high proportion of the relatively poor involved in smallholder coffee production, trade liberalization has had equalizing effects. But in Mexico, where the rural poor are concentrated in food production and education levels are still low and unequally shared, income declined between 1986 and 1996 for every decile of the income distribution except the richest, where it increased by 15 percent. Unfortunately Mexico is probably more typical than Costa Rica. For the region as a whole, though trade liberalization is likely to increase average incomes, it is also likely to increase inequality, at least in the near future. This because education efforts have lagged and because the region's comparative advantage (other than in Costa Rica and Uruguay) is in capital-intensive rather than job-creating natural resource-based production.

A second market reform is privatization. Privatization of utilities (power, water, and telecommunications) has been good news for the lower deciles of the income distribution all over the developing world because it has dramatically increased access to services. Prior to privatization, publicly managed utilities were chronically insolvent financially and thus their services were highly rationed. The rich had access to water to fill their swimming pools (and often at artificially low prices meant to protect to the poor) while the poor paid 20 times the unit cost to purchase water from private trucks.

On the other hand, it is increasingly obvious that privatization poses grave risks of concentrating wealth unless done well and with the full complement of regulation. In small economies with limited competition and high concentrations of political and economic power, even privatization of firms that in larger settings with more arms-length and transparent market rules would face the discipline of competition, can end up locking in rather than eliminating private privileges. In a recent poll in Latin America, respondents agreed by three to one to the general statement that "a market is best". But in Argentina, Peru, Colombia, Uruguay and Panama, fewer than half supported the idea that privatization had been beneficial

– apparently because of the widespread perception that the high costs of newly privatized services reflect lack of real competition. Russia is of course the most extreme example of the danger that corruption will infect the privatization process. The privatization of banks in Mexico in the early 1990s, and the subsequent political fallout in 1998 (when a sound proposal from the technical point of view was nearly derailed by the political effects of the 1995 rescue of many insider bank owners and borrowers) exemplify the political risks associated with a privatization process that ends up reinforcing rather than diffusing initial inequality of wealth and privileges.

The risks of privatization arise because developing and transitional economies, almost by definition, are handicapped by relatively weak institutions, less well-established rules of transparency, and often, not only high concentrations of economic and political power but a high correlation between those two areas of power. These conditions combine to make it difficult indeed to manage the privatization process in a manner that is not unequal.

Third: financial liberalization. On the one hand, there is little doubt that low- and middle-income consumers and small and medium businesses were the biggest losers in the 1980s with the repressed banking systems of Latin America. Controls on interest rates reduced their access to any credit at all, and government-run credit allocation favored small enterprises only on paper. Similar arrangements almost surely penalized the middle class and the poor in Africa. In the medium term, elimination of financial repression and the increased competition of a modern and liberalized financial sector will increase access to credit for small enterprises and raise the return to the banking deposits that are the principal vehicle for small savers. The advantages for small business in turn are likely to generate more good jobs and raise wages for the working poor.

However in the short run at least, financial liberalization tends to help those most who already have assets, increasing the concentration of wealth which supports a high concentration of income in the medium term. For one thing, liberalization increases the potential returns to new and more risky instruments for those who can afford a diversified portfolio and therefore more risk, and who have access to information and the relatively lower transacting costs that education and well-informed colleagues provide. In Latin America, with repeated bouts of inflation and currency devaluation in the

last several decades, the ability of those with more financial assets to move them abroad (often while accumulating corporate and bank debt that has been socialized and thus eventually repaid by taxpayers) has been particularly unequal. In Mexico between 1986 and 1996 small savers who kept their assets in bank savings accounts lost about 50 percent, while those able to invest in equity instruments realized modest gains. Those who moved their assets into dollars or dollar-indexed instruments before the 1994-95 devaluation did best of all in terms of local purchasing power.

Globalization itself. Of course, for developing countries, the effects of greater integration into global markets on inequality can come directly, as well as through domestic market reforms. Consider the effect of more globally integrated capital markets. High inflows of capital generate inflationary pressure and hurt labor-intensive agriculture and manufactured exports, especially but not only under fixed exchange rate regimes. In Asia and Latin America, Gini coefficients of inequality increased during the boom years of high capital inflows in the mid-1990s, as portfolio inflows and high bank lending fueled demand for short-term inelastic assets such as land and stocks, favoring the rich. In both regions the poor gained less during the boom, and then lost more with the bust. During the bust, with capital fleeing, the high interest rates countries are forced to impose to protect their currencies (again, whether the exchange rate is fixed or floating), hurt small capital-starved enterprises and their low-wage employees most, and of course reduce employment in general. In Latin America, a high-interest environment also tends to benefit net savers and hurt small debtors, with a regressive impact; this has certainly been the effect in Mexico and Brazil. The fiscal cost of bank bailouts in developing countries is probably regressive, if only because as Keynes reminds us, public debt implies a transfer from taxpayers to rentiers. Worst of all in Latin America's historically inflation-plagued economies (though this is notably much less the case the today), the poor hold cash, the non-interest bearing part of the debt which has been subject to considerable inflation tax.

Moreover, the problem emerging markets face is a broader one. Global market players doubt their commitment to fiscal rectitude at the time of any shock. Therefore, they are forced into tight fiscal and monetary policy, to re-establish market confidence, at precisely the moment when in the face of recession they would ideally implement counter-cyclical fiscal

and monetary measures in order to stimulate their economies. The austerity policies that the global capital market demands of emerging markets are precisely the opposite of what the OECD economies can afford to implement. Such measures may include relatively automatic Keynesian stabilizers as unemployment insurance, increased availability of food stamps, and public works employment programs, the ingredients of a modern and effective social safety net. Furthermore we know now that the effects of unemployment and bankruptcy on the poorer half of the population can be permanent; in Mexico increases in child labor force participation and reduced enrollment in school during the 1995 downturn have not been reversed. Similarly a collapse in employment opportunities for labor force entrants can have lifetime effects on job possibility and income-earning potential for the affected cohorts.

Policy implications. On the domestic policy side, one obvious implication of the vulnerability of emergent market economies to volatility in global capital availability is to reduce reliance on foreign capital. If public spending in developing countries is to play a socially and economically efficient counter cyclical role during a downturn, public savings in the form of a prior and precautionary fiscal surplus has to have already created the necessary fiscal space to finance safety net programs. Today Brazil has virtually no such fiscal flexibility, and is paying a price in increasing inequality. Chile does have space, and any increase in inequality will be lower. Of course, maintaining and insulating politically a fiscal surplus is no easy task – as the current politics-of- the-surplus debate in the U.S. shows.

In addition, the developing countries face the same problem as the OECD countries: raising revenue to finance a social safety net requires taxing the public. In a global economy, there is some evidence that it is increasingly difficult to tax footloose capital (and even to tax the income of highly educated and internationally mobile labor). Singapore and South Africa have recently reduced corporate taxes. Countries, ironically, need to tax most in good times those who are most vulnerable in bad times – and to the extent these are the innocent bystanders to the excesses of the boom and bust cycles, the impression if not the reality of unfair burden sharing is heightened.

Assured revenue for an effective safety net minimizes the welfare and human capital losses the poor otherwise suffer with economic or other shocks. But in the medium run, the

best vaccine against inequality is widespread access to good education. In today's global information age, education is the people's asset; the more there is of it, the lower the inequality of real total wealth in the long run. It is still unfortunately the case that in many countries of Latin America, education is a vehicle for reinforcing rather than compensating for initial differences across households in income and wealth. Unfortunately, it is a vicious circle. Education for the poor is a political and technical task made all the more difficult where high current income inequality, as in Latin America, constrains effective demand of poor households and generates resistance of rich households to use of the public funds to finance effective basic schooling.

A third key ingredient of domestic policy to counter inequality is what might be called an aggressive EOF bias, i.e. constant and vigorous Equal-Opportunity Fine-tuning of economic policies. For example, if macroeconomic equilibrium requires high interest rates, temporary measures to ensure equal access to credit for small and micro enterprises may be warranted. If a major restructuring of the financial sector is required, distribution considerations demand that bank shareholders assume their share of losses; not all the costs should be passed to depositors and taxpayers. In Peru, for example, privatization schemes can make special provisions under which small investors can buy small lots of shares, and can borrow at reasonable rates to purchase available shares – as has been tried. Or as in Bolivia, privatization schemes can be arranged to generate widely distributed benefits for all citizens in the form of future pension assets.

In the short-run, market reforms and global integration can increase inequality or make a decline less likely. After all, markets reward assets. Thus there is a premium on public policies that affect the distribution of assets. This brings me to my second point.

Inequality can undermine effective social policy

It is now widely acknowledged that the design and implementation of effective social policy in developing countries is no easy task. In the 1980s and early 1990s, the widespread assumption was that macroeconomic and structural reforms could be easily complemented by increased social expenditures as a way to put a human face on the adjustment process. That was what social policy meant. Now there is increasing focus on the difficulties of implementing the "second

stage" of reforms, where institutional capacity and broader consensus are needed to overcome formidable technical and political barriers to modernization and rationalization of government social programs.

I want to focus for a few minutes on the constraint that high-income inequality poses to implementation of effective social policy. The constraint arises on the demand side and on the supply side.

Consider first the demand for human capital. Latin America's large endowment of natural resources historically has limited society's demand for education. The socioeconomic arrangements that accompanied large-scale agricultural production and natural resource extraction involved relatively few owners of capital and many unskilled workers. There has thus been little demand for skilled workers, in part because natural resources tend to be complementary to capital, not skilled labor, in production. This is one message of the IPES 1998. Perhaps as a result, governments and families in Latin America have invested relatively little in education, given average income levels, seeing relatively higher returns to physical capital. A rich natural resource base in the region also minimized the need to develop competitive nontraditional exports in the early postwar period, thus perpetuating traditional production arrangements.

Second, high-income inequality in Latin America has implied that more households are liquidity-constrained, unable to borrow and without the resources necessary to keep their children in school. In 1989 Brazil and Malaysia had similar levels of per capita income. But the poorest quintile in Brazil had only about one-half the absolute income level of the poorest quintile in Malaysia. Given an income elasticity of demand for secondary education of 0.50 (a conservative figure), if the distribution of income had been as equal in Brazil and Malaysia, secondary enrollments among poor Brazilian children would have been more than 40 percent higher. There is some evidence that, among the poor, the income elasticity of demand for basic schooling exceeds 1.0, in which case secondary enrollments among poor Brazilian children would have been more than 80 percent higher.

Thirdly, household demands for education is not only a function of household income and household access to borrowing. It is also a function of expected returns to the family from schooling, in the form of higher future income for educated children. Two different public policies have systematically reduced the demand for basic education and other forms

of human capital among the poor by reducing its expected returns.

First, postwar Latin American governments pursued import-substituting industrialization policies in an attempt to shift away from exporting primary commodities and to promote local manufacturing. These ISI policies resulted in large subsidies and protection for the owners of capital, but did not promote demand for labor. As increased profits accrued to the owners of capital, real wages declined for the unskilled workforce. Relatively low wage growth among workers, combined with high returns to capital, did nothing to encourage demand for basic education among the poor. Additionally, some Latin American labor markets have discriminated against certain ethnic, linguistic or racial groups that also tend to be poor. This discrimination has reduced the expected returns to education among these groups and further reduced the demand for education among the poor.

The second problem has been educational policy itself. Low and declining quality of basic education in Latin America has reduced returns to basic schooling in the region, especially for poor households whose children are likely to attend the lowest-quality schools. High repetition and dropout rates in Latin America, especially among the poor, are sad testimony to parents' initial efforts to enroll children, and their growing discouragement as low quality and low achievement limit their children's learning and the expected economic returns.

At the same time, the supply of education in Latin America has been affected by the region's high-income inequality. When the distribution of income is highly unequal, providing subsidized basic education and health to a large proportion of poor households implies a relatively large tax burden on the rich. Though it is difficult to directly document, it seems likely that high income families have succeeded at least in some countries in resisting that tax burden, in part because they foresaw limited benefits to themselves. One result was, until recently, the underfunding of education, especially primary education, even in the prosperous years before 1982 —and a decline in quality. A second result has been the channeling of public subsidies to higher education, where children of the rich are more likely to benefit. In fact, a high share of the region's public spending on education is allocated to higher education—more than 20 percent on average, compared to 15 percent on average in East Asia. Venezuela and Korea are extreme examples. While in the early

1990s Venezuela allocated 35 percent of its public education budget to higher education, Korea allocated just 8 percent of its budget to post secondary schooling. Public expenditure on education as a percentage of GNP was actually higher in Venezuela (5.1) than in Korea (4.5). However, after subtracting the share going to higher education, public expenditure available for basic education as a percentage of GNP was considerably higher in Korea (3.6) than in Venezuela (1.3).

Compounding the problem on the supply side is the fact that it costs more to reach the poor. Given any percentage of government expenditures raised via taxes and devoted to social programs, the country with a larger proportion of households below the poverty line faces higher costs in producing the same human capital outcome compared to a country with a smaller proportion below that line. Why? The poor are likely to reside in rural areas, where the costs of attaining the same degree of public access are greater. More important, the poor are usually less productive in "producing" human capital, of which the publicly financed input is only one and often a relatively small input. Health and education outcomes are in fact produced by households, using a combination of inputs, including housing, food, parental attention and so forth as well as public health and education services. Of course this also implies that at the margin the return to a public expenditure on social programs may be higher for the poor than for the non poor – though even this may only be true once above a minimal level of home-produced input.

In summary, income disparities complicate the lives of well-intentioned designers and administrators of sound social policy. Income disparities are usually associated with higher costs of reaching those who have the least income and higher average costs for producing the same increment in human capital per unit of public spending. At the same time, income disparities may increase the resistance to government's raising and directing revenues to expenditures on social programs, especially those most likely to benefit most the poor.

There are reasons to be optimistic. First, the opening of trade and capital markets means the business sector has an increasing interest in supporting education, health, child development and other social programs. Structural reforms and rapid technological change are already making the lack of secondary school graduates a badly felt bottleneck in some countries. It is increasingly understood that to maintain competitiveness in a global economy requires a more skilled

and flexible labor force, especially given the relatively high wage levels in Latin America compared to Asian competitors in export markets.

Second, declining fertility rates in the 1980s are finally diminishing what had been for three decades tremendous pressure on the school system to accommodate more and more children every year. As quantity levels off, there is now room to focus on quality. This is one aspect of the demographic window of opportunity that was discussed this morning.

Third, the region's democratization is spurring the growth of civil society groups (NGOs, community groups, and increasingly pluralistic labor movements) that are more effective constituencies for better education and other social investments, especially among the poor, where individual parents have traditionally had little voice.

In conclusion

There is now more than ever a premium on good institutions and imaginative economic and social policy. This is especially the case in Latin America, where managing inequality is a race with time. Can the consolidation of democratic institutions (the rule of law, effective institutions of civil society, political parties that function well and labor unions) keep pace with, or even outrun, the tensions that globalization brings? Can the benefits of globalization outpace the risks? There are reasons for hope. There are good reasons for vigilance and imagination, too.

*These remarks elaborate on presentations made in March at an Overseas Development Council Conference, in Washington, DC, and at the Annual Meetings of the Inter-American Development Bank, in Paris.