

Trade and Poverty in Latin America



Inter-American Development Bank

Paolo Giordano
Editor



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Inter-American Development Bank
1300 New York Avenue, N.W.
Washington, D.C. 20577
www.iadb.org

Produced by the IDB Office of External Relations

The views and opinions expressed in this publication are those of the authors and do not necessarily reflect the official position of the Inter-American Development Bank.

**Cataloging-in-Publication data provided by the
Inter-American Development Bank
Felipe Herrera Library**

Trade and poverty in Latin America / Paolo Giordano, editor.

p. cm.

Analytical material exhibited and discussed at a conference titled Trade and Poverty in Latin America and the Caribbean, held at Inter-American Development Bank Headquarters, June 19, 2006.

Includes bibliographical references.

ISBN: 978-1-59782-099-8

1. Latin America—Commercial policy—Social aspects—Congresses. 2. Poverty—Latin America—Congresses. 3. Latin America—Economic integration—Social aspects. I. Giordano, Paolo. II. Trade and Poverty in Latin America and the Caribbean (2006 : Washington, D.C.). III. Inter-American Development Bank.

HF1480.5 T73 2009

337 T758--dc22

LCCN: 2009932634

Publisher a.i.: Gerardo Giannoni

Editor: Steven B. Kennedy

Proofreader: Michael Harrup

Editorial Assistant: Cathy Conkling-Shaker

Cover Design: Fernando Ronzoni

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Foreword

The Inter-American Development Bank (IDB)—led by the Integration and Trade Sector (INT)—pioneered a formal, open, academic dialogue and learning process both within and outside the Bank on the social and distributive impacts of trade integration in Latin America. After almost two decades of regional trade reform, it was clear that substantial research and case-by-case project implementation were needed to enhance understanding of the welfare implications of tariff liberalization and trade agreements at the firm and household levels, and overall on poverty reduction. The subsequent state-of-the-art knowledge and on-the-ground experience acquired are expected to nourish an institutional, pro-poor trade agenda. This will help advance the implementation of complementary domestic policies that maximize the benefits and mitigate the potential costs associated with progressive trade integration in the region.

Understanding the social and economic impacts of trade policy, building on that knowledge, and designing ways to take full advantage of the potential offered by global market integration are especially propitious—not only for obvious welfare considerations but also to improve the prospects of advancing on the regional trade agenda. Indeed, although cross-country experiences vary, on average the extent of trade reform has not matched proportional reductions in overall poverty in Latin America, damaging the perception that trade policy is a net welfare generator, particularly among the most vulnerable. Given the multiple factors affecting poverty, gains from trade integration have been significantly less visible than costs, such as job losses in traditionally protected and labor-intensive sectors. In this context, regional initiatives for greater trade liberalization are under systematic political pressure.

With the support of the Trade and Poverty Trust Fund established with the financial contribution of the U.K. Department for International Development (DFID), the IDB is supporting several initiatives that together embody a comprehensive strategy to address the issue. On the analytical side, the IDB is facilitating the gathering of experts in international academic forums to

disentangle the linkages between trade openness and poverty and to identify relevant areas for further research; collect cutting-edge knowledge from leading specialists in the field; and develop advanced quantitative techniques to assess the social, distributive, and poverty impacts of trade reform.

As initially anticipated, the stock of groundbreaking knowledge obtained from the IDB's research initiatives is stimulating the progressive implementation of its operative trade and poverty agenda in the region. Research pointed to (i) a relatively limited understanding of the implications of trade and poverty; (ii) the urgent need to generate a domestic, trade-related, enabling environment; and (iii) the benefits of including low-income families as active participants in export-value chains. These issues are pivotal to the IDB's emerging propoor trade agenda, which includes (i) engaging in ongoing dialogue with national authorities to inform them about the expected poverty effects of trade agreements under negotiation; (ii) promoting the implementation of country-specific, complementary policies to amplify the opportunities associated with trade openness among stakeholders, such as policymakers at the national or subnational levels and in the private sector, civil society organizations, and academia; and (iii) mobilizing resources and technical assistance to identify and fund pilot programs that grant sustainable access to global markets for excluded communities at the bottom of the socioeconomic pyramid, and small and medium-sized enterprises.

This book is the first IDB publication on trade and poverty. It includes some of the analytical studies sponsored by INT and the DFID Trade and Poverty Trust Fund. These studies, as a whole, portray the current state of knowledge regarding the social and distributive impacts of trade integration and offer contrasting points of view on the potential of trade openness to reduce poverty. Most of the studies and insights contained herein were part of the analytical material discussed at the conference "Trade and Poverty in Latin America and the Caribbean." This information is complemented by further documentation on the topic, sponsored and carried out by the IDB.

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Acknowledgments

This book is the result of a long-term project of the Integration and Trade Sector (INT) of the Inter-American Development Bank that would not have been possible without the support of the Trade and Poverty Trust Fund established with the financial contribution of the U.K. Department for International Development.

The editor is indebted to Antoni Estevadeordal, Manager of INT, who has supported the development of this line of work since its beginning.

Several colleagues also contributed to this project in different forms and at different stages. Among them a special acknowledgment is due to Robert Devlin and Ernesto López Cordova, who were key partners in the initial development of the project, and to Francesca Bastagli and Tim Kessler, who helped in drafting part of the introduction.

Finally, the outstanding support of Julio Guzmán, who contributed with vision and dedication to the last phases of this project, is to be commended.

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Toward a Propoor Approach to Economic Integration

Paolo Giordano

Scholars and policy experts met at a conference titled “Trade and Poverty in Latin America and the Caribbean,” convened by the Inter-American Development Bank (IDB) and supported by the Trade and Poverty Trust Fund established with the financial contribution of the U.K. Department for International Development (DFID). Participants were asked to identify knowledge gaps in the impact of trade integration on poverty and to specify necessary steps to address those gaps.

The Bank identified three main objectives for the conference: (i) highlight areas in which knowledge of the poverty impact of trade integration is incomplete, (ii) understand the challenges in designing and implementing propoor policies in the context of trade integration, and (iii) define a work program for assessing the impact of trade liberalization on poverty reduction and the adoption of propoor trade-related strategies in the region.

While a few participants came from the IDB and DFID, most came from other institutions, reflecting the organizers’ intention to learn about wider perspectives. In particular, the three core background papers discussed in the conference were prepared by Pranab Bardhan (University of California at Berkeley), Albert Berry (University of Toronto), and Alexander Schejtman and Julio Berdegú (International Farming Systems Research Methodology Network, Latin American Center for Rural Development).

This book presents, essentially, the analytical material exhibited and discussed at the conference. Although most of it comes from the event proceedings, the subjects emerged from the lively give-and-take of roundtable discussions and background papers. The publication also benefits from the inclusion of two additional papers (Paolo Giordano and Victoria Florez, IDB; and Xavier Sala-i-Martin, Columbia University) that serve to make it more comprehensive.

The book is organized as follows. The remainder of this introductory chapter summarizes central arguments—including points of consensus and disagreement—that emerged from the material presented. Section 1.1 addresses what we know—and especially what we don’t know—about the relationship between trade integration and poverty. It identifies knowledge and data gaps and suggests areas on which to concentrate future empirical work. Section 1.2 focuses on appropriate policy responses to help governments prepare for free trade; for example, how to negotiate agreements and what kind of requirements and conditions should be in place before (or, in the case of most countries, after) entering into multilateral and bilateral free trade agreements (FTAs). Section 1.3 presents feasible policy options that governments should pursue—and that institutions such as the IDB may support. Section 1.4 concludes.

The next five chapters, which constitute the body of the book, are presented following a top-down approach. In chapter 2, Bardhan introduces a global approach to the trade and poverty debate, identifying areas of consensus, methodological pitfalls when assessing the distributive impacts of trade policy, and key topics for further research. Giordano and Florez, in chapter 3, conduct a regional analysis of the available empirical evidence on the nexus among trade reform, inequality, and poverty in Latin America, providing one of the most wide-ranging literature reviews available. The inventory comprises the most influential studies focused on the region, carried out using a variety of methodological approaches.

In the two subsequent chapters, the analysis moves toward the sectoral dimension of the trade and poverty connection. Because wages are the primary source of a household’s income, they are important to look at when tracking poverty outcomes. Berry, in chapter 4, examines in detail the recent trends in labor markets in the context of unprecedented structural reforms in Latin America and, more specifically, explores the repercussions of progressive trade liberalization for urban employment. The rural economy dominates the discussion in chapter 5. This sector suffers the highest poverty incidence in the region but at the same time shows significant potentialities for poverty reduction due to its labor-intensive character, the presence of competitive advantages in some exportable agricultural commodities across the region, and the substantial room available for multilateral, cross-border trade liberalization. Schejtman and Berdegúe analyze current trends in poverty and inequality indicators in rural Latin America and review the existing stock of empirical evidence addressing the potential social impacts of trade integration

on the rural sphere. The authors conclude by proposing a framework for rural development that acknowledges the importance of undertaking empirical analysis at the subnational level, and taking seriously the differences in the productive structures and institutional arrangements across localities when assessing the effects of trade liberalization on welfare.

Chapter 6 ends the book with a case study. Here, Sala-i-Martin takes a brief look at the expected growth, employment, and poverty outcomes in the Colombian economy resulting from an FTA to be signed with the United States. In an optimistic assessment, the author estimates that the gains accrued by the Andean country would be even greater than those already reported by existing studies, since most empirical methods do not capture the dynamic effects of trade (increased specialization, technological progress, change in institutional arrangements), which, in his opinion, constitute the bulk of the anticipated benefits. The author, however, highlights the need to build a propoor domestic agenda to enhance the potentialities of the agreement, particularly through the adoption of public policies to strengthen safety nets, attract foreign investment, promote institutional change, and foster private sector competitiveness.

1.1 The Evidence on Trade and Poverty: Consensus, Concepts, and Challenges

It has become a truism that economic integration creates winners and losers. On the negative side, trade can increase poverty through employment lost (or wages eroded) by competition. Other negative impacts include increases in social inequality and the informal sector. More positively, integration can help countries open or expand export markets, attract foreign investment, acquire and absorb production technology, and enhance competition and efficiency. Yet many countries that open trade and capital markets fail to take advantage of these opportunities.

Reviews of trade literature by Bardhan, Giordano and Florez, Berry, Schejtman and Berdegué, and Sala-i-Martin in the chapters of this volume point to a conclusion that may be controversial in certain circles: economists do not know very much about the cause-effect linkages between trade and poverty. Numerous studies analyze the relationship between indicators of economic openness and labor market and poverty outcomes. These studies highlight three major challenges.

First, as each of the chapters suggests, there is little agreement about the linkages among trade, growth, and poverty. In some of the economic studies, trade liberalization is associated with improved welfare for the poor, in others with declining welfare. Some studies reveal significant growth and poverty impacts, while others suggest that trade doesn't make much difference.

Second, even where significant correlations are found in the studies, the conclusions are made at such a highly aggregated level that we cannot specify when or how countries are more likely to reap the gains of free trade. For example, Berry argues that our predictive capabilities are limited by research that offers primarily average findings and general conclusions. When there is no specification of the conditions under which trade will generate benefits, the data do not translate into useful policy recommendations for countries with distinct circumstances. Similarly, Bardhan laments what he considers an overreliance on aggregate cross-national studies and calls for more microstudies to provide insight into how trade liberalization affects domestic politics and policy choices.

Third, differences in empirical findings depend heavily on how trade, inequality, and poverty are conceptualized and quantified. In that regard, Giordano and Florez refer to the different ways these variables can be measured and expose the major advantages to and pitfalls of performing quantitative analysis. Just citing an example, measurement errors and data-availability problems are of particular importance when using outcome and policy-oriented trade indicators, such as trade shares (export and import flows as a fraction of gross domestic product, GDP) and tariffs, respectively. The first are highly correlated with (i) a set of macroeconomic policies affecting well-being through different channels and (ii) structural, country-specific preconditions (geography, demographics, and so on). Tariffs, although the best available approximation to trade policy, suffer from three drawbacks: they are too aggregate, do not capture information on the other increasingly important trade restrictive measures such as nontariff barriers (antidumping and countervailing duties, safeguards, food safety standards, and rules of origin), and cross-country data coverage, over time, is still limited.

A common approach to assessing the average effects of trade, reflected in the conference's core papers, is to review basic macroeconomic, social, and labor market data during the period in which countries opened their economies. Following earlier research, in chapter 4 Berry pegs the "starting date" of economic liberalization around 1980, and compares the ensuing two

■ BOX 1.1 The Language of Globalization

The debate over trade is characterized by terms with ambiguous definitions. The popular press, social activists, and critical economists often use words and phrases such as *Washington Consensus*, *liberalization*, *market reforms*, and *economic integration* interchangeably. The economic literature might be expected to add some clarity, yet it often falls into equally troubling errors of conflation, lumping together reforms designed to remove market distortions, protect investors, or increase efficiency.

Even a venerable term like *free trade* has multiple meanings in popular and professional discourse. For those who use the General Agreement on Tariffs and Trade as a reference, free trade is simply the reduction of tariff and nontariff barriers on physical goods. Since the creation of the World Trade Organization and the General Agreement on Trade in Services, free trade includes the reform of domestic regulations in the services sector, which contributes more to national output than manufacturing and agriculture in most countries. Bilateral FTAs frequently include a wider range of provisions, among them those protecting investment and property rights as well as defining guidelines for government procurement and dispute settlement procedures.

Some terms have highly specific meanings that must be clarified to distinguish particular arguments or phenomena. For example, while financial liberalization may be conceived as a market reform and part of the Washington Consensus, many claim that its impacts differ significantly from those associated with other forms of deregulation. Similarly, much of the content of FTAs has little to do with economists' theoretical conceptions of free trade.

This volume—reflecting the proceedings of the conference that inspired it—uses the terms somewhat interchangeably to reflect intensified economic transactions. Globalization may be understood—at least in its broad, economic dimension—as “the increasing degree of economic interaction among countries, reflected especially by rising shares of world output that are traded internationally and by rapidly expanding international capital flows” (Berry, 2006). Liberalization refers to “reductions in government intervention in markets, partly with respect to international interaction but also more generally as with labor markets, domestic financial markets, and so on. It involves giving product and factor markets greater responsibility in resource allocation in an economy” (Berry, 2006).

decades unfavorably to the period 1950–80, in which growth and poverty reduction were far more robust (see Box 1.2).

Yet the beginning of the reform period is not necessarily clearly marked, even in Latin America, the region that undertook the earliest and deepest reforms among developing countries. Commenting on the core presentations at the conference, Inter-American Dialogue President Peter Hakim objected to the “before and after” characterization of liberalization. He noted that it may not be appropriate to mark the early 1980s as the beginning of the market-reform period. While many Latin American countries were undertaking

■ BOX 1.2 Growth, Poverty, and Employment in Latin America since the 1980s

The region expanded at an average annual rate of 5.5 percent between 1950 and 1980. Since 1980 growth has averaged less than 2 percent, although it has recovered to 2.8 percent since 2004. Between 1950 and 1980 poverty fell significantly, from 65 percent to 25 percent. During the 1980s it rose to 35 percent, and it has settled back down to around 25 percent. During the reform period women became a much larger proportion of the workforce.

Labor markets have been troubled during the reform period. Open unemployment grew from 6 percent in the early 1990s to 8.5 percent in the early 2000s, despite modest growth. Growth of the labor force slowed to 2.25 percent between 1990 and 2002, but was still ahead of employment growth, which stood at 1.9 percent. Labor productivity grew slowly at 0.7 percent. From 1990 to 2000, wage growth in manufacturing slowed to 1 percent.

Informality has grown steadily since the beginning of the reform period, leveling off in the mid-1990s at almost half the labor force. Although evidence suggests it has stopped growing, it also has not gone back down, suggesting structural labor market weakness. Manufacturing has fallen as a share of total employment during the reform period, especially in the Southern Cone, a trend whose interpretation depends on the level of importance one assigns to industrial production. Finally, returns to higher education have risen significantly, contributing to the increase in social inequality.

Source: Berry (2006).

harsh reforms, these were clearly a response to the hyperinflation and debt crises that had resulted from previous policies, including the excesses of the 1970s. Moreover, countries within the region undertook reforms in different years, in different sequences and at different paces. Perhaps most importantly, governments implemented the policies with vastly different levels of political commitment and administrative competence.

Hakim's caveats suggest some of the difficulties encountered when generalizing about policy impacts during large periods of time. But the core presenters at the conference demonstrated a high degree of consensus on a central point: no matter how it is defined, qualified, or dated, economic integration has not been a panacea for growth or poverty reduction. Policy implications of this conclusion are further explored in section 1.2.

Trade, Poverty, and Inequality

As Bardhan observes in chapter 2, a common complaint in many countries is that the rich get richer while the poor stay poor (or get even poorer). In the last two decades, critics of globalization have assigned blame—and their

culprit is economic integration. Yet before even addressing the question of cause, Bardhan first explores the trends in poverty and inequality. His review of data reveals the following: (i) intercountry disparity in per capita incomes is, indeed, increasing, but this measure is based on a system of counting in which each country has equal weight regardless of its population; (ii) when income levels are weighted by population, disparities actually decrease—mostly as a result of poverty-reduction gains in the world's largest countries, including China and India; (iii) intracountry inequality is increasing in some countries but either it is decreasing or the data are ambiguous in others; and (iv) considering both population-weighted intercountry inequality and intracountry inequality, the 2006 *World Development Report* reports a small decline in combined inequality between 1988 and 2000.

In terms of poverty, the developing world as a whole (with or without China) shows a decline between 1981 and 2001, with the greatest progress in East and South Asia. The aggregate improvement masks poverty increases in certain regions and countries, especially in Latin America and Sub-Saharan Africa.

While the data on global poverty and inequality trends seem to be moderately positive, there is no accepted theory about the role of globalization in such trends. As IDB's principal labor advisor, Gustavo Márquez commented at the conference that the analysis of the role of economic integration in distributional outcomes is complicated by the existence of other important events that occurred roughly at the same time, especially in Latin America. In addition to technological change that has occurred over the last few decades, deeper trade liberalization was typically accompanied by the transition to democracy, which has fundamentally changed the government's relationship to unions and the mass populace.

Moreover, Márquez pointed out that trade liberalization has coincided with a near-universal rejection of policies that generated high inflation. Yet even as the region has shunned fiscal risk, many countries have welcomed financial risk through capital-market liberalization. The result has been a mishmash of policies and institutions that have influenced poverty reduction in distinct ways and make it extremely difficult to isolate trade as a uniquely consequential factor. Sala-i-Martin, in chapter 6, fully concurs and adds labor market rigidities and the preliberalization structure of protection as two additional potential sources of the observed wage inequality and poverty trends.

At the same time, circumstantial evidence about inequality suggests that trade liberalization does matter. Latin America is both the most unequal region in the world and the most liberalized developing region. Berry's review of the literature in chapter 4 concludes with a "reasonable guess ... that greater openness has been at least partly to blame for increased inequality in those Latin American countries that have suffered it in various periods." He notes that some countries have seen their Gini coefficients increase by up to 5 points, a significant increase that could indicate that trade plays a role in worsening inequality.

Much of the economic literature on the trade impacts on labor market and distributional outcomes uses computable general equilibrium (CGE) models to analyze such linkages under alternative scenarios. At the conference, Sandra Polaski, from the Carnegie Endowment for International Peace, reported findings obtained from a model designed at that organization to simulate the plausible outcomes of the Doha Round of international trade talks, also known as the Doha Development Agenda, which showed that "at the global aggregate level, any of the plausible trade scenarios will produce only modest gains." Such gains would amount to an increase of less than 0.2 percent of current GDP. The Carnegie study also indicates that the poorest countries would be among the net losers under all likely Doha scenarios.

Whether using global or country-specific data, models that relate globalization to either inequality or poverty are often built around questionable assumptions and simplifications. One example offered by Bardhan in chapter 2 is the nature of international competition. Models of free trade often utilize a simple two-country model in which capital and labor endowments are neatly distinct. In trade between the United States and China, for example, one country is more skilled and the other less skilled. But in the real world, trade (and competition) occurs among many countries whose advantages rise and fall according to a more complex distribution of endowments. Thus, if Mexico enters the model, one country is both more skilled and less skilled than a major trading partner.

Another example provided by Bardhan of how models can be influenced by dubious assumptions is worker mobility. Most models of trade assume that workers can move out of less productive employment and into more productive activities. Yet in the poorest countries, there are often major constraints on labor mobility. Imagine a three-product African country that produces coffee (by men), subsistence crops (by women), and processed food (imported). Because women typically have severely restricted mobility—a

possibility not taken into account in the Stolper-Samuelson model—trade liberalization might tend to worsen the situation for women.

Several conference participants argued that we still have much to learn from macro models and simulation tools, but joined Bardhan in calling for greater attention to the validity of assumptions. For example, several participants commented that CGE models using full-trade scenarios—for example, to simulate Doha impacts—ignore the fact that Doha does not entail full trade liberalization. Similarly, they cautioned modelers about formulating labor market assumptions concerning demand for unskilled labor.

Trade and the International Environment

While globalization and economic integration are often conflated, they can also become contradictory propositions. Conference participants agreed that integration policies that truly liberalize markets could—at least in principle—improve human welfare and reduce poverty in the long term. But several pointed out that, in the real world, “globalization” consists of a complex web of policies and practices, many of which are designed specifically to undermine market discipline, protect politically influential groups, and advance rent-seeking interests.

At the policy level, Bardhan suggested that regulations and standards can limit the profitability of exports or even impose costs so high that potential exporters give up trying. In particular, health and consumer safety regulations, in addition to the quality standards and standardization requirements of global distributors, can make commercialization a far greater challenge than production itself. Berdegúé reminded the conference that another aspect of globalization includes huge agricultural subsidies, which allow farmers in rich countries to escape competition from efficient poor producers and even flood markets in poor countries with underpriced crops.

Bardhan also pointed out that within the private sector, trading, distribution, and processing companies are often organized into cartels that reap the lion’s share of profit. Especially when dealing with small, geographically remote, and unorganized producers—such as poor farmers—these companies can offer prices far below the world price and adopt a negotiating position of “take it or leave it.” Similarly, marketing firms that add little value and offer no productive innovation can reap most of the profits from export transactions because of their linkages to brand-name suppliers.

Finally, several conference participants identified global capital as an important dimension of the international trade environment. Much has been written about how global financial markets have undermined stability in the “real economy”; channeled capital into speculative, unproductive activities; created pressures to take risks in search of short-term, high-profit ventures; and triggered massive currency crises. Several participants agreed that financial liberalization was carried out naively and undermined macroeconomic stability throughout the developing world. At the same time, domestic policy largely determined the influence of global capital markets on the “real economy.”

Trade and Domestic Factors

Because the various manifestations of globalization affect countries in different ways, it is clear that domestic conditions, institutions, and policies mediate the effects of integration. One of the main points of agreement to emerge from the conference was that the benefits of free trade and investment are greatest for countries that have the institutions and policies required to take advantage of global markets. Taking the agriculture sector as an example, Schejtman and Berdegúé noted numerous domestic factors that can influence the degree and distribution of trade impacts, including income and asset inequality, agricultural relations and land concentration, rural education, food retail and distribution systems, employment and income diversification, quality of institutions, regulations and transaction costs, ethnicity and gender, infrastructure quality and geographic distribution, rural finance and credit access by small and medium-sized enterprises, and quality of innovation diffusion systems.

Conference participants made references to three areas of domestic policy in particular. One area was finance policy. While capital markets have become deeply globalized, capital-market liberalization remains a national policy decision. While conference participants broadly agreed on the benefits of liberalizing trade and removing restrictions on foreign investment, several openly questioned the value of liberalizing capital markets—especially in the context of fiscal and monetary policies that overvalued the exchange rate. Indeed, participants made a point of distinguishing both the characteristics and outcomes of trade and investment reform (believed to be a good policy overall) and capital-market imbalances (a risky proposition). For example, Berry argued that capital-market-liberalization policies have tended to worsen financial market imbalances between large and small firms.

Another domestic policy area discussed was the environment for small business. As Bardhan elaborated at the conference, small, self-employed firms typically lack access to formal credit or insurance, need better infrastructure, and have few, if any, resources for marketing their goods. They also face government regulations and rent-seeking behavior that undermines competitiveness and incentives to take risks: oppressive red tape, insecure legal rights, petty corruption, and so on. Thus constrained, it becomes extremely difficult for the self-employed poor to withstand competition from large business, whether foreign or domestic. In such situations, opening product markets internationally without addressing weak or distorted factor markets—such as credit or infrastructure services—may be a suboptimal policy. The unfavorable poverty outcome that results is fully consistent with the “second-best” welfare economics of international trade theory: product-market liberalization need not improve welfare if input market imperfections remain.

Finally, conference participants emphasized that domestic competition affects trade impacts. The prospects for local producers are influenced by the efficiency and quality of critical services, such as banking, telecommunications, transport, energy, retail and distribution, and institutions. Several participants, including professional economists, complained that economists tend to focus on international competition but ignore competition within countries, where business elites and monopolies often engage in rampant rent seeking.

Agriculture

Because most of the world and Latin America’s poorest people live in rural areas, the performance of the agricultural sector is particularly relevant to the issue of poverty. As detailed by Schejtman and Berdegúe in chapter 5, during the reform period growth has been uneven for staples (basic grains) and traditional exports (except sugar). Most countries have seen a significant increase in imports of staples. But FTAs have not always been the main cause. Weather conditions, increases in domestic demand, and government decisions to unilaterally drop agricultural barriers have been primary causes of the import boom. FTAs have helped fuel sustained growth for nontraditional exports, such as fruits and vegetables.

Schejtman and Berdegúe argue that the last two decades have given little reason for optimism about the potential for agricultural trade to overcome rural poverty. Since the 1980s the number and proportion of rural poor in

Latin America has increased. Extreme poverty has grown faster than nonextreme poverty, meaning that the poor are now poorer. The poverty rate among small-scale producers has worsened relative to overall rural poverty for 10 of 14 countries they examined (only Brazil, Colombia, Honduras, and the Dominican Republic have seen improvement; even Chilean small producers have experienced greater poverty). While geographic proximity to markets is likely to be a factor in some instances of poverty, it is not decisive. About half of the region's rural poor live near areas that have reaped benefits from agricultural trade.

There are large variations among the world's regions, among countries within those regions, and among areas within countries. In general, rural inequality is high, with Gini coefficients ranging from 45 to 63. Improvement has been minor and slow. (Urban inequality has been even higher and progress even slower.) High levels of rural inequality can be explained largely in terms of an extremely wealthy rural elite.

Schejtman and Berdegúé conclude that the main channels through which trade liberalization affects rural poverty are labor markets and agricultural demand. Evidence indicates that the highest potential returns from trade are derived from land, while returns to agricultural labor are much lower. This insight means that asset distribution becomes an "initial condition" that influences how the benefits from trade reform are distributed throughout the countryside.

One important aspect of "globalized" agriculture discussed by Schejtman and Berdegúé is the persistence of massive subsidies. In the United States, European Union, and Japan, government support of farmers who already have important capital and technological advantages has been a major factor in low levels of public support for the Doha Round of the World Trade Organization (WTO) and the widespread perception that benefits of agricultural trade are skewed toward the rich. Subsidies are also common in developing (and, in particular, middle-income) countries, and in some cases may rival the per capita levels seen in rich countries, when adjusted for purchasing power parity. But in general, agricultural adjustment policies have been weak or poorly designed, with elites and wealthy producers capturing the lion's share of the benefits.

The Labor Market: Employment and Informality

Evidence of the impact of trade integration on employment is mixed. Ironically, the acceleration of modernized production, one of the main benefits associated

with integration, may be a culprit in disappointing labor outcomes for the poor. As Berry observed at the conference, “one of the likely mechanisms on the trade side is that openness has encouraged labor-displacing technology to reduce the price of capital goods, encouraging use of modern technology to produce the quality levels required in rich countries.” Polaski concurred, arguing that it is at least a plausible outcome that trade destroys more jobs than it creates. Because in some countries the jobs created are likely to be more capital intensive, overall employment could decline even as efficiency increases. One outcome of such trends is a high level of anxiety. Public opinion surveys reveal that a very high share of Latin Americans (85 percent in 1996–7 versus 32 percent in European countries) are either unemployed or worried about losing their jobs (Berry, 2006).

■ BOX 1.3 Economic Integration and Inequality: Identifying Linkages among Wage Earners and the Self-Employed

A variety of theoretical models provide some clues about the causal processes that may be driving the observed relations between globalization and inequality. One set of models focuses on wage inequality and explains why trade liberalization may have led to a rise in the skill premium both in the rich (presumably skill-abundant) and poor (presumably skill-scarce) countries. In most of these models, the rise in wage inequality is due to a shift in relative demand of skilled labor across industries.

Some studies question the importance of such shifts in explaining the rise in wage inequality and emphasize the role played by trade-induced shifts within an industry, with firm heterogeneity and differential quality upgrading. Still others focus on trade-induced, skill-biased technical progress, and show that some developing countries facing competition from imports of cheap, unskilled-labor-intensive products from poorer countries may adopt skill-biased “defensive innovations.”

In addition to affecting wages in the formal sector, economic integration can impact inequality through its effects on the self-employed. In most Latin American countries the self-employed poor work on their own tiny farms or as artisans and small entrepreneurs in shops and household enterprises. The usual constraints they face are in credit, marketing and insurance, and infrastructure and government regulations.

Openness to foreign trade and investment may help in relieving some of the bottlenecks in infrastructure and services in essential parts, components, and other intermediate products like fertilizers and pesticides. At the same time, even when increasing the main incomes of the poor, it may heighten their vulnerability, particularly by increasing prices or income volatility. Whether in a particular case variability increases or not can only be resolved empirically. There is, however, a consensus on the low capacity of the poor to cope with negative price and income shocks.

Source: Bardhan (2006).

At the same time, there appears to be a positive relation between trade and workforce skill levels. William Maloney, lead economist in the World Bank's Office of the Chief Economist, presented evidence at the conference indicating that (i) workers make better wages as human capital increases and (ii) firms involved in global trade demand workers with higher levels of human capital. Empirical work could help provide more insight into this relationship. But Maloney made the plausible argument that in the meantime, it is good news that production of tradable goods requires more skills.

Another trend that trade critics often ascribe to economic integration is labor informality. There is considerable evidence that the incidence of informal employment has grown significantly since the 1980s, with informal employment now typically covering about half of all employment in the region. From a fiscal perspective, the trend is troubling, since informal workers don't pay income tax. But from a social perspective, there may be less reason for concern, as evidence does not establish a clear linkage between informality and trade.

Maloney presented evidence suggesting that the main causes of informality are rooted more in domestic policies, particularly in labor regulation. In Argentina, the trend toward greater informality began well before the country undertook trade liberalization, and has continued afterward. In Mexico, the North American Free Trade Agreement (NAFTA) appears to have had no discernable effect on levels of informal labor. In Brazil it has been estimated that trade liberalization accounts for about 10 percent of informal employment. Maloney cited existing research that concludes that constitutional changes and policy reforms have made a much bigger difference. For example, universal health insurance and pensions might make formal employment less urgent. The implications of such findings are worth pondering, since the reforms that may reduce incentives to join the formal labor force are also considered to have important poverty-reduction impacts.

1.2 Domestic Policy Responses to Globalization

Much of the debate over globalization surrounds an implicit disagreement about the valid counterfactual case. Some conference participants responded to the growing chorus of critics suggesting that developing countries would be better off today had they retained barriers to trade and investment and that propoor policies should include a return to economic nationalism. Even

free-trade skeptics such as Bardhan find this pill too bitter to swallow, largely because they see domestic policies and institutions as key determinants in economic outcomes. As Bardhan writes in chapter 2, “Closing the economy does not reduce the power of the vested interests: landlords, corrupt or inept politicians and bureaucrats, and the currently subsidized rich.”

Economic studies should be careful to qualify their observations—and especially their predictions—regarding the impacts of economic integration on poverty by noting that outcomes are mediated by policy choices and institutional environment. For policy observers such as Peter Hakim, it is frustrating to learn that while free trade *can* improve welfare among society’s poor, under certain conditions it may have no effect or even make the poor worse off. As noted in the previous section, aggregated cross-country data are not readily translatable into useful policy for specific countries.

Although conference participants expressed considerable uncertainty about what economic integration actually does to (or for) poor people, they strongly agreed that governments have a responsibility to pursue propoor policies. The policies discussed fall into two basic types, with each addressing a distinct goal. The first is informed by the premise that integration can create losers. The goal is to *minimize the unfavorable impacts* caused by competition: unemployment or underemployment, the loss of services or resources linked to jobs, reduced wages, and so on. Thus the first set of policies can be described broadly as coping mechanisms that promote social protection.

The second policy area is based on the premise that integration can create winners. The goal here is to *maximize the benefits* derived from reduced barriers, especially those in which poor people can share: exporting to formerly protected markets (for small producers, this usually means selling to distribution firms), supplying local firms that produce for export, and moving up the value-added chain. The second set of policies thus addresses the constraints on exploiting new economic environments.

Social Protection and Adjustment Assistance

Social protection includes a wide array of policies ranging from those aimed at protecting against certain risks, such as job loss or displacement, to policies designed for particular vulnerable groups, independent of their relation to the labor market. At the conference, IDB labor economist Carmen Pagés presented evidence on trade and labor and poverty outcomes suggesting that

social-protection policies play an important role both in acting as safety nets and in helping the vulnerable react to possible adverse trade impacts.

As discussed above, one channel through which trade impacts welfare is through job reallocation and job loss. Although evidence on such linkages is limited, studies indicate that in Latin America, one in three jobs is created or destroyed every year. According to Pagés, trade liberalization accelerates this churning, even though the effect is small. For those who lose their jobs, displacement is costly. The costs of displacement are higher in recession, in poor areas, and for tenured workers. But there is a lack of data to differentiate those who lose their jobs because of trade from those who do so as a result of other factors. This is one reason why it may be advisable to pursue social-protection systems that protect different social groups and categories of workers from a variety of risks, not only those derived from trade-related shocks.

Pagés argued that the job-reallocation process in Latin America tends to be costly and inefficient, since workers typically have little time and few resources to spend looking for new work. Governments provide little or no assistance to workers in moving from lower- to higher-productivity employment. Social-protection reforms are thus a win-win proposition: they make risk sharing more equitable and improve efficiency. They may also make trade reforms more acceptable. From a political economy perspective, social protection is an important policy instrument that helps create the political preconditions for economic integration and associated domestic reforms. Along the same line of thinking, Sala-i-Martin asserts in chapter 6 that intelligently designed safety nets should provide effective assistance to displaced workers to adapt to new environments, capitalizing on newly developed skills and avoiding the creation of a class of people permanently dependant on welfare programs.

Politicians not only want to avoid hurting constituents, they want to avoid scaring them. As public opinion polls reveal, there is a difference between actual job fluctuations and anxiety about losing jobs. For example, Bardhan reported at the conference that in several Scandinavian countries, high degrees of economic openness are accompanied by government programs to maintain incomes and improve the skills of those who lose their jobs. Such arrangements have helped ensure strong support for economic integration by the trade unions. Conversely, the lack of such programs clearly contributes to Latin America's high employment anxiety, which in turn has led to a standstill and even a reversal in liberalization policies throughout the region.

In addition to income-support programs, a new generation of social-protection instruments includes “active-labor-market” policies, which are designed to help displaced workers get new (and income-equivalent) jobs quickly. They typically involve job-search assistance and training, although the latter has not proven very effective in the highly informal labor environment of Latin America. Evidence from the region has led Pagés to call for the introduction of a combination of social-protection measures, including conditional cash transfers to the poor, and public works programs. Such policies serve a dual function: providing a coping mechanism and reaching those excluded from the formal labor market. They can be accompanied by “activating” programs such as job-search assistance and training. Country experiences suggest that such programs can build on technical and organizational innovations, such as the Internet and public-private partnerships.

Efforts to improve adjustment-assistance policies should tailor social-protection systems to particular countries and avoid blueprinting experiences from dissimilar national or economic contexts. An underlying principle is to target the poorest workers, not only those affected by trade. This promotes equity and helps avoid the technical and administrative difficulties of identifying trade-related job losses.

Obstacles to Exploiting Export Markets

The experience of poor farmers, artisans, and small manufacturers suggests that efficient production is not enough to take advantage of free-trade opportunities. The other key challenge—an area in which most small producers have little experience—is actually selling goods in international markets. As Bardhan put it at the conference, while international trade theory is mostly about the comparative costs of production, it should focus increasingly on the comparative price of commercialization.

Several conference presenters argued that the level of trade-impact analysis is often too highly aggregated to be of much practical value to policymakers. As James Riordan from Chemonics International pointed out, even the most specific economic research tends to be focused on an entire productive sector. Taking advantage of his experience as a trade and development practitioner, he maintained that production decisions are ultimately based on opportunities for individual firms, not industries, and that when policymakers speak of creating jobs through exports, they are implicitly referring to the creation of

sales that create the demand for new workers. When it comes to international trade, if you build it—and even if you build it well and affordably—they still may never come.

Having worked with in-field companies, Riordan complained that development programs are fundamentally supply driven, even if they use the rhetoric of demand-driven production. They usually begin with an existing product and provide assistance in “marketing” the product to potential customers. For Riordan, a truly demand-driven approach would conduct a market analysis first and adjust production to satisfy that market—or more accurately, to satisfy the requirements of distributors who supply that market. Moreover, in the real world, small farmers do not sell food to foreign households: they sell to food traders or supermarkets, which have to comply not only with national health and safety requirements, but also with privately developed quality standards. Except in local markets, artisans do not sell handicrafts directly to consumers: they sell to retailers that bring in masses of shoppers.

Riordan discussed policy implications for a demand-driven approach that creates opportunities for actual businesses, rather than simply promoting a positive business environment. These include:

- *Resources.* Governments can assist small producers in reducing the transaction costs involved in complying with regulatory and quality standards. Programs that help firms with inspection, testing, and official certification can make producers far less risk averse. More ambitiously, governments can work with producer associations to diffuse technical and quality-assurance processes that help firms meet the strict quality standards of global distributors. Small producers typically lack access to formal credit needed for expanding or modernizing production. Government programs can provide incentives for private lenders to take risks on small producers.
- *Finding the middleman.* Many small firms have good products or good ideas, but do not know which retailers or distributors might be interested in developing them. Getting that information can be prohibitively expensive for a producer lacking capital, information technology, and marketing skills. Governments can do more in creating user-friendly databases that help producers identify and contact potential corporate customers.
- *Trust.* In developing countries, mutual suspicion between suppliers and traders is common. Producers who have to invest their time and capital

■ BOX 1.4 Costs of Complying with International Standards

Governments of wealthy countries routinely encourage poor countries to get richer by entering global markets. But because of both legitimate public interest concerns and pressure from protectionist interests as well, they have erected some of the most onerous barriers to small and poor exporters. To sell in the world's most lucrative markets, producers incur significant costs in both meeting stipulated standards and demonstrating compliance with those standards. Historically, governments in North America, Europe, and Japan have imposed numerous health and consumer-safety requirements. Particularly for agricultural goods, complying with sanitary and phytosanitary standards typically involves inspection of goods and facilities and certification.

In addition to government-imposed regulations are those issued by the private sector. For example, EUREPGAP is a private safety standard set by a group of European supermarkets. Its requirements are more onerous than current "organic" food standards and act as formidable barriers to market entry. European supermarkets now insist that farmers comply with myriad health and safety rules, product testing, farm audits, and staff training. Audits alone cost around \$500 per farmer, exceeding average annual income in many parts of Africa. Some evidence suggests that tighter control by retail chains over suppliers to ensure standards has led to a drastic decline in the proportion of exports from small farmers.

Similarly, in manufacturing goods and services it is costly for small producers in poor countries to establish a name and quality reputation in international markets, which usually requires the services of multinational marketing chains.

Source: Bardhan (2006).

fear being exploited or cheated by large and well-connected traders. Traders struggling to meet major contracts worry that small producers will be unable or unwilling to deliver goods on time, with sufficient volume and adequate quality. Government can help build social capital between both groups by facilitating communication, such as by sponsoring trade fairs where they can meet and make deals. Development agencies can play an even more direct role, serving as liaisons between distrustful producers and distributors and communicating with both sides to gradually build up confidence.

1.3 Assessing Practical Policy Alternatives

Those calling for a rethinking of trade policy often express frustration over the black-and-white nature of the public debate. At the conference, Bardhan expressed frustration over the simplistic portrayal of economic issues in public discourse:

globalization champions repeat flawed conclusions about trade benefits without questioning data or methodologies; dissenters blame trade for seemingly every problem a country faces; and the media amplify this dialogue without providing context, nuance, or detailed analysis. Much of the conference discussion focused on how development professionals could continue to analyze highly complex relationships and outcomes while promoting a public dialogue about basic principles and fundamental trade-offs that should inform any assessment of policy options.

Taking Political Economy Seriously

Those leading the effort to reevaluate the relationship between trade and poverty carry a message about contingency. Liberalization can bring important benefits to the poor, but only when certain conditions are pursued. This message is surely valid, but has disturbing political implications. Bardhan concludes chapter 2 on a positive note whose implications might seem quite challenging for many poor countries:

Globalization . . . can . . . eliminate some jobs and entrepreneurial opportunities for the poor and for small enterprises. But in the medium to long term it need not make the poor, as a whole, much worse off *if appropriate domestic policies and institutions (particularly for support infrastructure to help production reorganization, labor-market adjustment, and social protection) are in place and if appropriate coordination among the involved parties can be organized* [emphasis added]. Societies with institutions that can better coordinate social protection and economic restructuring, and that can ensure that the winners share some of their gains with the losers, are better placed to cope with the turbulence that globalization necessarily involves. If the institutional prerequisites can be managed, globalization opens the door for some new opportunities, even for the poor.

While it is difficult to disagree with this qualified conclusion, the conditions described beg an important question. How many of the world's poorest countries—and the poorest regions within developing countries—actually have the “appropriate domestic policies and institutions”? Moreover, among those lacking these conditions, how many are likely to acquire them in the

near future, how long will it take, and what are the obstacles that stand in the way of progress?

A revealing example is Mexico, a middle-income country whose institutional development, human capital, and economic diversity are all quite strong by regional standards. Yet as Hakim pointed out at the conference, Mexico has had over a decade to adjust to NAFTA and has made little progress, especially in areas that mean the most to poor people, such as agriculture. How can we expect that other countries will suddenly create and implement effective programs to compensate losers and enable potential producers to export to global markets?

Another example—raised several times by Bardhan—is the issue of labor mobility. Numerous studies suggest that globalization is simply not compatible with labor immobility, especially in agriculture. Rural workers, especially women, cannot escape low-wage activities or move to potentially profitable ones when they are geographically circumscribed. Thus, there is a broad agreement that obstacles to mobility should be at the center of concerns about adjusting to integration. Yet the development field has—surprisingly—little to say about the different causes of labor immobility, and even less to say about how to overcome it. Constraints in many countries include not only political and social pressures to restrict worker movement, but potentially even thornier obstacles related to culture, race, and gender.

Perhaps even more than the economic and technical challenges, political and social constraints represent a serious reality check on the potential for most countries to reap the benefits from economic integration. One of the strongest arguments for adopting FTAs in developing countries is to “import” efficiency-enhancing rules from abroad. Yet it is not realistic to expect free trade to change a country’s institutional fundamentals instantly. Recalling a discussion about measures to compensate losers from the Central America Free Trade Agreement or prepare small businesses to compete, one conference participant highlighted the importance of public trust in local authorities and in their capacity to actually implement policies that benefit the poor. The anxiety stems from the fear that the elite will capture the lion’s share of public resources.

Policies designed to achieve “optimal” outcomes are often political nonstarters. As Anthony Venables from DFID put it at the conference, to define a work program that will generate influential findings, economists need to assess “live policy options, not theoretical ones.” This means taking

seriously the constraints imposed not only by the institutional machinery of globalization, but also by domestic interests.

During the discussion on the conference's three core presentations, one economic analyst argued that a country's "initial condition" matters a great deal. He maintained that trade liberalization alone is not going to change the social or political fundamentals of a country. If a country is unequal, then integration may simply deepen inequality, while countries that are more equal may find it easier to diffuse the benefits of trade. He thus suggested that in the very poorest countries and regions of the world, economic integration can bypass, if not damage, the poorest people.

FTAs versus Free Trade

Part of any reality check in the study of trade and poverty involves shifting attention from abstract notions about liberalization to concrete provisions of bilateral, regional, and multilateral FTAs. As Polaski insisted at the conference, FTAs are not the same thing as free trade. First, they go beyond trade, including provisions on finance, investment, and services. Second, they impose explicit restrictions on trade and domestic production, through provisions such as intellectual property protection and local content rules, as well as more traditional quotas, tariff phaseout periods, and exemptions. Since much of Latin America already operates under (or is actively negotiating) bilateral accords that incorporate such provisions, the reality check on policy options should focus analysis on existing FTA constraints and opportunities.

When economists focus on the gains from unencumbered free trade, they generate impressive predictions about poverty reduction that do not necessarily correspond to realities that developing countries confront. As Hakim noted with considerable frustration, as the assumptions and methods underlying extremely positive poverty reduction scenarios have been challenged, predictions about trade impacts have become much more conservative. He and Polaski referred to significant changes in World Bank predictions about free trade benefits. According to a *Washington Post* account, the Bank initially predicted:

[T]hat freeing international trade of all barriers and subsidies would lift 320 million people above the \$2 a day poverty line by 2015. Now [December 2005], however, Bank economists project the figure at between 66 million and 95 million people. And even that assumes the WTO negotiators would

completely abolish tariffs, quotas and other obstacles to commerce—a fanciful scenario, calculated only to show what a maximum deal would produce. Assuming a more plausible outcome in which the WTO members agree to some deep cuts in tariffs and subsidies, while they stop short of pure free trade, the reduction in the number of people below the \$2-a-day line by 2015 would be only about 6.2 million to 12.1 million people, the Bank now reckons. That is less than 1 percent of the people living below the line.

An analysis from the Carnegie Endowment for International Peace suggests that gains from a “moderately ambitious” Doha scenario would result in a 0.14 percent global gain. Using the same data, the World Bank predicts a gain of 0.12 percent. (The gains for unskilled labor are estimated at 0.6 percent, higher than aggregated gains but still quite small.) In Latin America, projected gains are smaller than the global average, with demand actually dropping for large middle-income countries such as Mexico and Brazil.

Moreover, in qualitative terms, certain participants expressed pessimism regarding the prospects for Latin America’s bilateral North-South accords. Predictions that such accords will not have a positive impact on the poor are based on the observation that in a context of asymmetric power relations, a mercantilist approach to trade negotiations undermines the equitable distribution of costs and benefits. The antipoor features of most preferential bilateral FTAs include:

- Opening up agricultural markets without addressing agricultural subsidies, which enables seemingly more competitive producers to outsell efficient Latin American producers in their home markets and prevent potential exporters from making gains in their own domestic markets.
- Making open markets for manufactured goods contingent on rules of origin that reduce efficiency and prevent regional producers from utilizing low-priced inputs.
- Intellectual property rights (IPRs) provisions that extend the time horizon for monopoly profits and increase the price of products that can provide significant benefits to the poor.

Although this issue was hotly debated during the conference, lofty statements about the ideal preconditions for reaping the potential benefits of these agreements ring hollow at this point. If countries lack the policies and

infrastructure and institutions to make economic integration work for the poor, they need to adopt an aggressive agenda without delay.

Directions for Future Research

There was a growing consensus among conference participants that aggregate data, while useful for understanding distributional outcomes of trade liberalization, are not enough. Several presenters called for micro-level studies on the interaction between trade policy and poverty outcomes. For example, Venables argued that it is necessary to integrate data from household surveys with administrative and other data sources. In addition, empirical work should disaggregate economic sectors and specify the institutional and policy environment, including different actors involved (such as trade unions), labor market characteristics (including worker characteristics and degree of informality), and the role of adjustment assistance (including safety nets and social insurance mechanisms).

Venables also pointed out that the norm has been to supply research without directly consulting those most affected by the policies being assessed or proposed. He suggested that economists can improve their analysis and specificity by finding out what stakeholders themselves are struggling with. This would require learning more about interactive social science methods or working with more interdisciplinary research teams.

Future research should also focus on specific empirical and analytical gaps. These include:

- *Distributional impacts of trade liberalization.* Research should clarify the nature of the policy being analyzed. Trade liberalization should be distinguished from economic integration. Moreover, different types of liberalization, as reflected in different agreements (that is, multilateral versus bilateral) and specific provisions within those agreements, should be evaluated.
- *Labor supply response to free trade.* Where lack of labor mobility is a major cause of poverty persistence (or increase) after trade liberalization, economists need to better understand the root causes of labor immobility. Market causes may include rigid credit markets. Regulatory causes may include formal sector labor laws. Cultural causes could include race and gender relations.

- *Political economy.* Economists should produce case studies (as opposed to anecdotes or highly aggregated cross-country exercises) that provide insight into how political economy pressures mediate policies that respond to trade liberalization, as well as economic outcomes themselves. To contribute to this body of research, they could collaborate with analysts from other fields, such as sociology, anthropology, and political science.
- *Informality.* Although informal labor comprises a significant amount of the paid work done in Latin America, the understanding of informal labor markets is sparse and based on questionable data. For obvious reasons, most data are drawn from the formal sector. Because of the difficulty of obtaining information—and perhaps because informally employed people don't pay income taxes—almost half of the economy is being virtually ignored. Noting that most research is focused on how to move people from informal to formal sector jobs, there is also a need to know more about how to increase the productivity of informal workers.
- *Firm-level and business-focused analysis.* To understand technical change and quality upgrading—as well as their relationship to income distribution—it is necessary to go beyond sectoral analysis and study plant-level operations directly. Business-focused analysis should also include case studies on how global competition—or industrial concentration through mergers and acquisitions—affects the monopoly practices of transnational companies and retail market chains, particularly with respect to the hefty margins charged for marketing the products of developing countries under international brand names. Of particular interest would be insights into what resources and organizational capabilities help small firms negotiate effectively with global companies.
- *Social protection and adjustment assistance.* There is little detailed information about the impact of adjustment assistance and social-protection mechanisms in cushioning trade impacts. Yet a central hypothesis is that trade liberalization can help the poor if compensatory measures are in place. Many countries might not have the resources to set these up. In others, public expenditures are regressive. There is a great need for detailed and up-to-date case studies of existing programs and social-protection systems (their design and implementation details, including financial arrangements and sustainability). In addition, future research could provide rigorous evaluations of existing safety nets, with a focus on their effectiveness in response to economic integration.

1.4 Conclusions

Most efforts to estimate the impact of trade integration on the poor involve abstract notions of free trade that bear little resemblance to actual FTAs. Yet in the real world, multilateral, bilateral, and regional accords are invariably drafted under mercantilist pressures. They also extend well beyond the traditional realm of trade in goods, with provisions affecting the regulation of capital movements, investment in service sectors, and enforcement of IPRs, among others. Economic analyses that focus on price effects resulting from tariff reductions to gauge distributional impacts are capturing only part of the story—and in many cases not the most important part.

While analysts can, at least in principle, learn the precise provisions of any given trade agreement, a far greater challenge is measuring a country's (or region's) institutional and developmental capacity to take advantage of opportunities in foreign markets. Economic competitiveness is affected not only by the capital and technology available to producers, but also by the efficiency and prices of basic domestic services that producers use. Moreover, even if domestic firms can produce efficiently, they must comply with onerous quality and health standards that private distributors and foreign governments impose.

Growing reluctance among economists to assert inevitable net benefits of trade integration reflects appreciation of this complexity. The field is beginning to move toward new methodologies, such as in-depth case studies, to better understand what is happening at the sector, firm, and household levels. Those who have led the critique of the Washington Consensus also appear to be more receptive to interdisciplinary approaches to the production of new research.

A more complex approach to analyzing trade integration is likely to yield more specific and differentiated policy recommendations. In particular, there is a need to gain better insights into how to unleash the productive potential of small and undercapitalized firms, and to learn more about how to design social policies that protect the unemployed and vulnerable and prepare workers for new jobs.

Finally, the evolving approach to economic analysis cannot ignore the political economy of poverty. As a rule, the poor are not as well organized as the nonpoor, and extremely poor people tend not to be organized at all. Their voice in the political process is typically weak, or represented by proxies such

as nongovernmental organizations, academics, or other groups. Discouraging as it might be to acknowledge, serving the interests of impoverished people is often a risky political strategy.

Better-organized groups—often including rent-seeking interests long accustomed to privilege—can be expected to fight to maintain or deepen policies that have little to do with poverty reduction. National governments will ultimately be responsible for designing programs and allocating resources that primarily help the poor to benefit from free trade, or at least to shield them from its unfavorable impacts. Analytical support from the international policy community can help political leaders to justify progressive new policies in the design and implementation of such instruments, and bring a propoor approach to economic integration closer to reality.

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APPENDIX 1.1
Conference Program
Trade and Poverty in Latin America and the Caribbean
 June 19, 2006—Inter-American Bank (IDB) Headquarters

Opening Remarks:

- Nohra Rey de Marulanda, Manager, Integration and Regional Programs, IDB
- Marco Ferroni, Deputy Manager, Sustainable Development Department, IDB
- Diana Melrose, Director, International Trade Department, U.K. Department for International Development (DFID)

Session I—What Do We (Not) Know about the Social Impact of Trade Integration?

Current Knowledge

Presentations:

- Pranab Bardhan, University of California at Berkeley—Trade, Poverty, and Inequality
- Albert Berry, University of Toronto—Trade and Labor Markets
- Julio Berdegú, Latin American Center for Rural Development (RIMISP)—Trade and the Rural Economy
- Alexander Schejtman, Latin American Center for Rural Development (RIMISP)—Trade and the Rural Economy

Comments:

- Peter Hakim, Inter-American Dialogue

Advancing an Analytical Agenda

Triggering Remarks:

- Ernesto López Córdova, Integration and Regional Programs Department, IDB

Presentations:

- Anthony Venables, International Trade Department, DFID
- Sandra Polaski, Carnegie Endowment for International Peace
- William Maloney, Office of the Chief Economist, World Bank
- Gustavo Márquez, Research Department, IDB

Session II—How Can We Improve the Design and Implementation of Pro-poor Policies in the Context of Increased Trade Integration?

Policy Experiences and Best Practices

Presentations:

- Diana Melrose, DFID
- Carmen Pagés, Research Department, IDB
- James Riordan, Chemonics International

Implications for the IDB

Triggering Remarks:

- Paolo Giordano, Integration and Regional Programs Department, IDB

Presentations:

- Gabriel Casaburi, Regional Operations Department I, IDB
- Mario Umaña, Regional Operations Department II, IDB
- Pablo Alonso, Regional Operations Department III, IDB
- Santiago Soler, Multilateral Investment Fund, IDB
- César Bouillon, Sustainable Development Department, IDB

2

Globalization, Inequality, and Poverty

Pranab Bardhan

Many people have strong opinions about the impact of globalization on the well-being of the world's poor. Often, convictions are in inverse proportion to robust factual evidence. Officials of international financial institutions and opinion makers writing for influential newspapers and magazines assert with confidence their belief in the value of global free markets to expand the horizons of the poor, while activist-protesters argue against this belief with passion. In the recent past, this division has turned the venues of many important international meetings into combat zones with excessive security arrangements surrounded by displays of absurdist theater in the streets.

As is common in contentious public debates, different people mean different things by the same terms—in this case, the word *globalization*. Some interpret it to mean the global reach of new technology (particularly in information and communication) and capital movements; some refer to the outsourcing of labor by companies based in rich countries; others protest the tentacles of corporate capitalism or U.S. hegemony. A large part of the opposition to globalization can be related to three points: (i) the fragility of valued local and indigenous cultures around the world under the onslaught of global mass production and cultural homogenization (through global brand-name products—movies, music, fast food, soft drinks, the Internet, the English language, and so on); (ii) the devastation of fragile economies caused by billions of dollars of volatile short-term capital stampeding around the globe in herd-like movements; and (iii) the damage to jobs, wages, and income of poor people caused by the dislocation and competition inherent in international trade and foreign investment and the weakened ability of

The original version of this chapter was prepared in 2005 and does not reflect the most recent contributions to the literature.

governments to compensate for this damage and to alleviate poverty and inequality in general.

While conceptually distinct, all three of these issues are interrelated. For example, indigenous ethnic handicrafts wiped out by imports of mass-manufactured products can be seen as both an economic and a cultural loss. Similarly, when short-term speculative capital rushes out of a developing country, this inevitably has adverse effects on the medium- to long-term investment climate.

This chapter focuses on the third interpretation—globalization defined as openness to foreign trade and long-term capital flows. It seeks to understand the possible difficulties that developing countries might have in forging policies to alleviate poverty and redistribute income when faced with international economic integration, defined as openness to foreign trade and long-term capital flows. To understand this we need, first, to examine the processes by which globalization can affect the conditions of the poor and, second, to analyze the ways in which the policies meant to relieve those conditions are hemmed in by global constraints. While, in general, globalization can cause many hardships for the poor, it can also open up opportunities that some countries use and others do not, depending largely on domestic political and economic institutions. The net outcome is often quite complex and almost always dependent on context, belying glib statements for or against globalization. This chapter also emphasizes the scope for international institutions to foster coordination among the involved parties and for public-private partnerships to resolve many of the controversial policy issues.

Regarding the first two points raised by opponents to globalization and mentioned above, this author generally favors some modest restrictions on the current fury of globalization. There are valid arguments for cultural protection¹ that even an economist can make: (i) the preservation of cultural diversity along the same lines as biodiversity and an “option value” in environmental economics; (ii) the fact that, when local, traditional production practices are replaced by global manufacturing, they may be irretrievably forgotten; and (iii) the different effects of endogenous choices made when options depend on the range of available varieties and those choices are shaped by giant international firms selling standardized products via huge advertising budgets.

¹ For an attempt to formalize these arguments in terms of theoretical models, see Aubert and others (2003).

Many of the financial crises in developing countries in recent years were initially caused by overexposure to foreign-currency-denominated, short-term debts. These financial instruments, everybody now recognizes, are particularly crisis prone. In most cases there was too little discipline in borrowing before the crises and too much discipline after. Many international economists (even those who otherwise support free trade) now believe in some form of control over short-term capital flows, particularly if domestic financial institutions and banking standards are weak—though there are different arguments about the specific form such control should take and about how to assess the effects of the rise in capital costs that this may entail. It is imperative for the international community to work toward the creation and supervision of some international hedging and insurance institution to counter the impact of capital flow volatility.

This chapter does not address the question of globalization as manifested in the flow of international labor or the increased migration of workers from poor to rich countries. If significant numbers of unskilled workers were allowed into rich countries, even in limited and regulated numbers, a large dent would be made in world poverty, many times what can possibly be brought about by other forms of international integration.² But very few—even among those concerned about the world's poor—seem prepared to entertain this “radical” idea, and the general rise in anti-immigration sentiments in many rich countries makes the current climate inhospitable to the idea.

Section 2.1 discusses the empirical evidence on the relationship between globalization, as it is defined here, and inequality and poverty. Section 2.2 examines the various ways one can try to analyze the causal relations among globalization, wage inequality, and poverty. Section 2.3 looks at the poor, both self-employed and not, as consumers. Section 2.4 considers the case of the poor as users of public and environmental resources, and section 2.5 describes the set of feasible policies that can alleviate poverty without relinquishing the gains of globalization and concludes with some suggestions for future research.

² Walmsley and Winters (2002) have estimated that the global gains from allowing even temporary entry of both skilled and unskilled labor services equivalent to 3 percent of the workforce in countries of the Organisation for Economic Co-operation and Development would amount to about 1.5 times the total gains from merchandise trade liberalization.

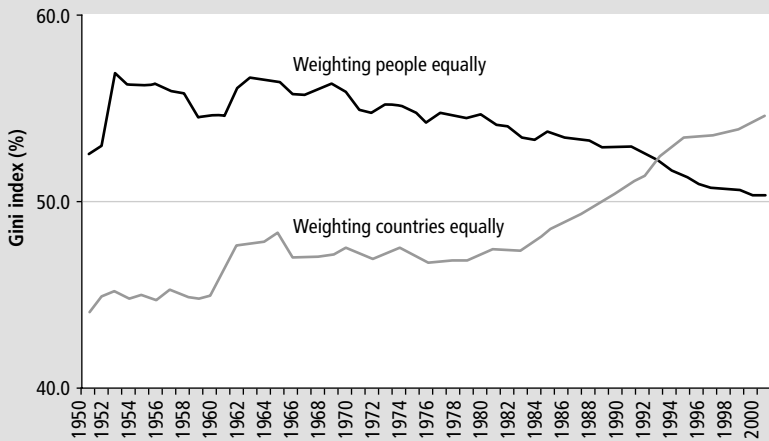
2.1 How Does Globalization Affect Inequality and Poverty?

Common wisdom tells us that globalization is making the rich richer and the poor poorer. The reality, however, is actually much more complicated and yields no easy or general answers. This chapter first reviews the evidence on inequality and poverty in the last two decades and then examines the question of how much is due to globalization. Regarding the evidence on changes in inequality,³ figure 2.1 gives the Gini indices for gross domestic product (GDP) per capita averaged across countries over the second half of the twentieth century under two alternative weighting schemes. The first is to weight countries equally, using the United Nations principle of “one country, one vote.” The second is to give people equal weight wherever they live. The weighting schemes give strikingly different results, particularly over the last two decades. The first scheme suggests a rise in inequality, while the second suggests a fall. The main reason for the difference over the last two decades is the substantial income growth in the two largest poor countries in the world—China and India. When people get equal weight, hundreds of millions of people in these two countries move to the middle of the world income distribution, rendering it less unequal overall.

Apart from intercountry disparity, this chapter also addresses intra-country inequality. For illustrative purposes, Appendix 2.1 charts movements in the Gini index for Argentina, Bangladesh, Brazil, Chile, China, India, Indonesia, Mexico, Nigeria, and Pakistan (which all together cover about two-thirds of the total population of the developing countries). They are derived from a somewhat incomplete World Bank database; comparable data do not exist for each country for some years in the 1980s and 1990s. Table 2.1 provides the Gini coefficients for the 10 study countries. Inequality appears to be rising in all of them during this period, although the household surveys—on the basis of which inequality estimates are made—often display an increase in the nonresponse rates of richer households over time, and thus may understate the rise in inequality or at least vitiate comparisons. When population-weighted intercountry inequality and intracountry inequality

³ Reference is made here to only relative inequality. Ravallion (2004) points to the simple fact that non-economists often have absolute inequality in mind when they talk about a rise in inequality. It is easy to see that even when relative inequality remains the same, when one person is twice as rich as another in both time 1 and time 2, the absolute gap between them may widen.

■ **FIGURE 2.1** Gini Indices of Gross Domestic Product Per Capita across Countries under Alternative Weighting Schemes



Source: Milanovic (2005).

are combined, the data for a larger set of developing countries are available for only a few recent years. The *World Development Report 2006* indicates a small decline in this combined inequality between 1988 and 2000.

What about absolute poverty statistics, or the percentage of people below an internationally comparable poverty line?⁴ Figure 2.2 gives the percentage of people living on less than \$1 a day at 1993 purchasing power parity (PPP). There is a declining trend in the percentage of poor people, though the decline is flatter if China is excluded. Table 2.2 gives a regional breakdown in these percentages between 1981 and 2001 for two poverty lines—approximately \$1 a day and \$2 a day. The declining trend in poverty is clear in most regions except Sub-Saharan Africa, Eastern Europe, Central Asia, and Latin America and the Caribbean (LAC).

Those in support of globalization point to the international economic integration and large decline in poverty in recent decades of China, India, and Indonesia—to take the world's three largest poor countries, long characterized by massive rural poverty. Chen and Ravallion (2004) have estimated that between 1981 and 2001, the percentage of rural people living below an

⁴ Many caveats should be kept in mind for measuring poverty by a common dollar (purchasing power parity) standard of poverty for countries in different parts of the world.

■ TABLE 2.1 Gini Coefficients from the World Bank's Povcal Database

Country	Year	Gini	Data Type
Argentina (urban)	1986	44.51	Income ^a
	1992	45.35	Income
	1996	48.58	Income
	1998	52.82	Income
	2001	52.24	Income
Bangladesh	1983–4	25.88	Expenditure
	1985–6	26.92	Expenditure
	1988–9	28.85	Expenditure
	1991–2	28.27	Expenditure
	1995–6	33.00	Expenditure ^a
	1996	33.63	Expenditure
	2000	31.79	Expenditure
Brazil	1981	57.57	Income
	1984	57.88	Income
	1985	59.52	Income
	1987	59.31	Income
	1989	63.42	Income
	1990	60.68	Income
	1993	59.82	Income
	1995	61.51	Income
	1996	59.98	Income
	1997	59.05	Income
	1998	60.66	Income
	2001	59.25	Income
Chile	1987	56.43	Income
	1989	57.88	Income ^a
	1990	56.49	Income
	1992	55.75	Income
	1994	54.79	Income
	1996	57.47	Income
	1998	56.65	Income
	2000	57.61	Income ^a
China (rural)	1990	30.57	Expenditure ^b
	1992	32.03	Expenditure
	1993	32.13	Expenditure
	1994	34.00	Expenditure ^b
	1995	33.98	Expenditure ^b
	1996	33.62	Expenditure
	1997	33.12	Expenditure ^b
	1998	33.07	Expenditure ^b
	1999	35.39	Expenditure
	2001	36.33	Expenditure
China (urban)	1991	24.78	Expenditure ^b
	1992	24.17	Expenditure
	1993	28.47	Expenditure
	1994	29.22	Expenditure ^b
	1995	28.27	Expenditure ^b
	1996	29.09	Expenditure
	1997	29.35	Expenditure ^b

Continued on next page

■ **TABLE 2.1** Gini Coefficients from the World Bank's Povcal Database *(continued)*

Country	Year	Gini	Data Type
China (urban)	1998	29.94	Expenditure ^b
	1999	31.55	Expenditure
	2001	33.32	Expenditure
India (rural)	1977–8	34.20	Expenditure
	1983	30.06	Expenditure
	1986	30.22	Expenditure
	1987	30.13	Expenditure
	1988	29.51	Expenditure
	1989	28.23	Expenditure
	1990	27.72	Expenditure
	1992	29.88	Expenditure ^a
	1993	28.59	Expenditure
	1994	27.65	Expenditure
	1995	30.17	Expenditure
	1995–6	28.43	Expenditure
	1997	30.56	Expenditure ^a
	1999–2000	28.11	Expenditure
India (urban)	1977–8	35.74	Expenditure
	1990	33.98	Expenditure
	1992	35.51	Expenditure ^a
	1993	34.34	Expenditure
	1994	33.31	Expenditure
	1995	37.49	Expenditure
	1995–6	37.06	Expenditure
	1997	36.52	Expenditure ^a
	1999–2000	35.00	Expenditure
Indonesia	1987	33.12	Expenditure
	1993	34.36	Expenditure
	1996	36.45	Expenditure
	1998	38.36	Expenditure ^a
	1999	31.73	Expenditure
	2000	30.33	Expenditure ^a
	2002	34.30	Expenditure
Mexico	1989	55.14	Income
	1995	53.73	Income
	1996	51.86	Income
	1998	53.11	Income
	2000	54.93	Income
Nigeria	1985–6	38.68	Expenditure
	1992–3	44.95	Expenditure
	1996–7	50.56	Expenditure
Pakistan	1987	33.35	Expenditure
	1990–1	33.23	Expenditure
	1992–3	34.22	Expenditure
	1996–7	27.43	Expenditure
	1998–9	32.99	Expenditure

Source: Ginis presented in this table come from the World Bank's PovcalNet. These data are probably individual-level Ginis, computed from household-level data, with a few exceptions (see Chen and others, 1994).

^a Assumed data type when this information was missing from both Chen and Ravallion (2004) and PovcalNet.

^b Assumed data type based on Chen and Ravallion (2004).

international poverty line of \$1.08 per day (at 1993 PPP) declined from about 79 percent⁵ to about 27 percent in China, from about 63 percent to about 42 percent in India, and from 55 percent to 11 percent in Indonesia. Contrary to repeated assertions in the international financial press, however, no one has convincingly demonstrated that this decline is mainly due to globalization. In China it could largely stem from internal factors such as (i) expansion of infrastructure, (ii) large-scale land reforms instituted in 1978, (iii) policy changes relating to grain procurement prices, and (iv) the relaxation of restrictions on rural-urban migration. That the spurt in agricultural growth following the 1978 land reforms may be largely responsible for poverty reduction in China is suggested by the fact that a substantial portion of the decline in poverty in the last two decades had already happened by the mid-1980s, before the large advances in foreign trade or investment.⁶ Similarly, the reduction of rural poverty in India may be attributable to the spread of the Green Revolution, to large antipoverty programs, and to social movements in the country rather than to the trade liberalization of the 1990s, which was largely confined to the nonagricultural sector. In Indonesia, sensible macro-economic policies, the active stabilization of rice prices, massive investment in rural infrastructure, and the Green Revolution played a substantial role in the large reduction of rural poverty between 1981 and 2001.⁷ By the early 1980s, the earlier oil boom was largely over, and by 2001 the economy had not fully recovered from the Asian financial crisis.

Those who are more dubious of global processes point out that poverty has remained stubbornly high in Sub-Saharan Africa during these decades. Table 2.2 shows that between 1981 and 2001, the percentage of people living below the poverty line of \$1.08 per day (at 1993 PPP) increased in Sub-Saharan Africa from about 42 percent to about 46 percent (the trend in the years in Table 2.2 is upward but not statistically significant).⁸ This may have little to do with globalization, however, and more to do with unstable or failed political regimes, wars, and civil conflicts that afflicted several countries (29

⁵ This figure actually refers to China in 1980.

⁶ Chen and Ravallion (2004) note that mean tariff rates in China fell only slightly in the 1980s and nontariff barriers actually increased. They show econometrically that growth in the primary sector (mainly agriculture) rather than in the secondary or tertiary sectors is largely responsible for the decline in poverty. They write, "Our data do not suggest that expanding trade can explain China's progress against poverty."

⁷ See Timmer (2004).

⁸ This refers to total population.

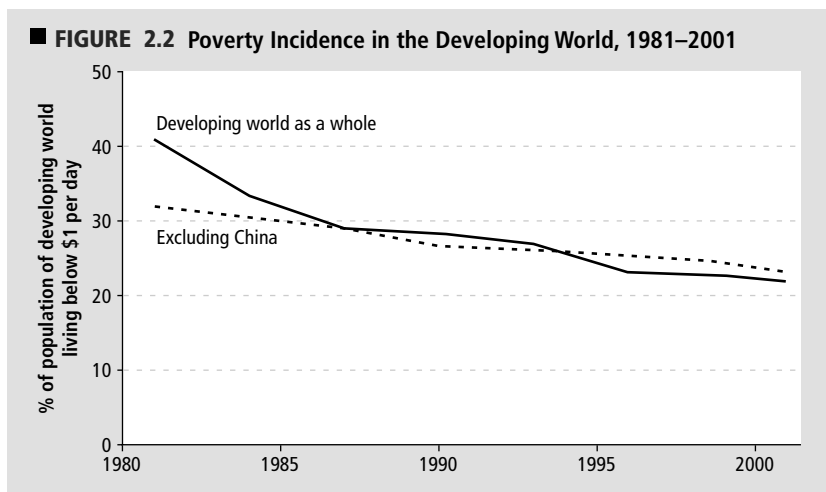
■ **TABLE 2.2 Headcount Indices of Poverty by Region for Two International Poverty Lines, 1981–2001**
Percent

Poverty Line and Region	1981	1984	1987	1990	1993	1996	1999	2001
\$1.08 a day (1993 PPP)								
East Asia	57.7	38.9	28.0	29.6	24.9	16.6	15.7	14.9
China	63.8	41.0	28.5	33.0	28.4	17.4	17.8	16.6
East Asia excluding China	42.0	33.5	27.0	21.1	16.7	14.7	11.0	10.8
Eastern Europe and Central Asia	0.7	0.5	0.4	0.5	3.7	4.3	6.3	3.6
Latin America and Caribbean	9.7	11.8	10.9	11.3	11.3	10.7	10.5	9.5
Middle East and North Africa	5.1	3.8	3.2	2.3	1.6	2.0	2.6	2.4
South Asia	51.5	46.8	45.0	41.3	40.1	36.6	32.2	31.3
India	54.4	49.8	46.3	42.1	42.3	42.2	35.3	34.7
South Asia excluding India	42.2	37.0	41.0	38.7	33.1	19.7	22.9	21.0
Sub-Saharan Africa	41.6	46.3	46.8	44.6	44.1	45.6	45.7	46.4
Total	40.4	32.8	28.4	27.9	26.3	22.8	21.8	21.1
Total excluding China	31.7	29.8	28.4	26.1	25.6	24.6	23.1	22.5
\$2.15 a day (1993 PPP)								
East Asia	84.8	76.6	67.7	69.9	64.8	53.3	50.3	47.4
China	88.1	78.5	67.4	72.6	68.1	53.4	50.1	46.7
East Asia excluding China	76.2	72.0	68.4	63.2	56.7	53.2	50.8	49.2
Eastern Europe and Central Asia	4.7	4.1	3.2	4.9	17.3	20.7	23.8	19.7
Latin America and Caribbean	26.9	30.4	27.8	28.4	29.5	24.1	25.1	24.5
Middle East and North Africa	28.9	25.2	24.2	21.4	20.2	22.3	24.3	23.2
South Asia	89.1	87.2	86.7	85.5	84.5	81.7	78.1	77.2
India	89.6	88.2	87.3	86.1	85.7	85.2	80.6	79.9
South Asia excluding India	87.3	84.0	85.0	83.5	81.0	71.3	70.5	69.0
Sub-Saharan Africa	73.3	76.1	76.1	75.0	74.6	75.1	76.0	76.6
Total	66.7	63.7	60.1	60.8	60.2	55.5	54.4	52.9
Total excluding China	58.8	58.4	57.5	56.6	57.4	56.3	55.8	54.9

Source: Chen and Ravallion (2004).

out of 43 countries in Sub-Saharan Africa in the 1980s and 1990s suffered civil conflicts). If anything, such instability only reduced their exposure to globalization by discouraging many foreign investors and traders. For LAC, the trend in poverty for the years in table 2.2 is downward but not statistically significant.

With respect to the inequalities in health-related indicators, the *World Development Report 2006* shows that, in 1980, the average life expectancy at



Source: Chen and Ravallion (2004).

birth in four regions of the world—West Asia and North Africa, East Asia (excluding China and Japan), South Asia, and Sub-Saharan Africa—was below the world average. In the first three of these areas, the high rates of growth in life expectancy during the next 20 years decreased inequality globally, whereas the decline in life expectancy in Sub-Saharan Africa in the 1990s increased inequality by stretching the bottom tail of the distribution. By 2000 only South Asia and Sub-Saharan Africa were still below the world average. While health indicators are generally much worse when incomes are low, differences in income growth explain less than one-sixth of inter-country variation in improvements in life expectancy. Major determinants of declining mortality include clean water, improved systems of public health and sanitation, basic sanitary knowledge, women's education, and so on. Deaton (2004) considers that the insufficient transmission of health knowledge, drugs, and technology; the annual preventable deaths of 10.5 million people in poor countries (preventable because they would not have died had they been born in rich countries); and the lack of treatment for HIV/AIDS for tens of millions of people in some of these countries constitute major failures of globalization.

There have been attempts to relate trade to income inequality on the basis of cross-country regressions. The results often vary, depending on whether the level of trade is related to the level of inequality or whether changes in the two variables are related. Milanovic and Squire (2006), for example, find

that openness hurts people in the poorer deciles in low-income countries when the analysis relates levels to levels, but they find no measurable effect when the analysis relates changes to changes.⁹ There have also been attempts using cross-country regressions to positively relate trade liberalization (measured either as tariff reduction or, less satisfactorily, as an increase in an outcome variable such as trade shares) with economic growth, and to relate growth to poverty reduction. The former relation is controversial, while many find more evidence for the latter.¹⁰ In any case, there are deep methodological and econometric flaws in such cross-country regressions, as well as acute problems in the reliability of data and thus the ability to compare across countries. For example, in the trade-growth regressions, instrumentation via lags on economic indicators has been tried, but this hardly offers a valid alternative if openness is serially correlated or other variables affect growth as much as trade. Regarding data-related problems, Deaton (2003) has argued that an observed correlation between aggregate growth and poverty reduction could be attributable to measurement error and to biases in national income statistics, which yield very different results for the magnitudes and trends in aggregate poverty relative to the household surveys. A microanalysis of the impact of trade liberalization on total factor productivity growth at the enterprise level gives mixed results. Even for the relationship between openness and levels of firm productivity, the evidence is quite ambiguous, as the survey discussed by Tybout (2000) shows.

The long-run effect of growth on poverty reduction is often noncontroversial. But the usefulness of the average estimated value of the elasticity of this effect—taken to be 2 in an estimate reported in the *World Development Report 2001* (that is, a 1 percent increase in real per capita income has been associated with a reduction in the headcount incidence of poverty by 2 percent)—is somewhat limited, since the underlying causal model is underspecified. Moreover, the value of the elasticity varies from country to

⁹ Earlier, Edwards (1997) found no significant effect when looking at changes in inequality in the 1970s and 1980s.

¹⁰ See Rodrik and Rodríguez (2000). Warner (2003) in turn has refuted some of the criticisms of the earlier literature made by the latter. Wacziarg and Welch (2003) shift the focus from cross-section to time-series and panel analysis and seem to support the view that trade liberalization has a positive impact on growth. Lee and others (2004) try an alternative methodology (“identification through heteroskedasticity”) to estimate the effect of openness on growth, finding it significantly positive but small, while controlling for the effect of growth on openness.

country depending on initial conditions, especially initial levels of income and the extent of social and economic inequality. It even varies a great deal within countries, especially large ones. Across states in India, Ravallion and Datt (2002) find that the elasticity of poverty reduction with respect to non-farm output growth varies depending on initial conditions such as literacy and land distribution.

There is now a large literature on the effect of globalization on wage inequality, particularly between skilled and unskilled labor. For example, in the mid- to late 1980s and the early 1990s, drastic reductions in tariff rates in Mexico and Colombia were accompanied by a rise in the skill premium. In Mexico, as Cragg and Epelbaum (1996) show, the skill premium increased by about 68 percent between 1987 and 1993.¹¹ In Colombia, as Attanasio and others (2004) report, the skill premium increased by 20 percent between 1990 and 1998. There is general agreement that this is more the result of an increase in the demand for skilled workers. But as Attanasio and others (2004) show, the skill premium alone cannot fully explain the observed increase in wage inequality in Colombia. What happens to trade-policy-induced industry wage premiums and trade union premiums may also be important. Using two large data sets on wage inequality across countries over the 1980s and 1990s, one from the Occupational Wages Around the World database and the other from the University of Texas Inequality Project, Milanovic (2005) finds that tariff reduction is associated with a rise in interindustry wage inequality (the industry premium) in developing countries (strictly, countries with lower than \$9,000 PPP per capita income at 1995 prices), and somewhat more weakly with interoccupational wage inequality (the skill premium) in those countries. Behrman and others (2003) do not find a significant impact of liberal trade regimes on wage differentials in Latin America, but financial liberalization and high-technology exports in the context of a liberal trade regime do contribute to a rise in wage inequality. In general, since trade reforms are often carried out in association with a host of liberalization, deregulation, and macroeconomic stabilization policies, apart from ongoing technological changes, it is difficult to disentangle the effects and isolate those of trade reform. Microstudies usually do a

¹¹ Milanovic (2005), however, reports that this finding for Mexico is not consistent with the occupational wage data for Mexico in the data set collected from the International Labour Organization sources by Freeman and Oostendorp.

better job in this respect, but they do not capture general equilibrium and growth effects.

What about the impact on absolute wage and employment levels? Wage income can rise and the absolute poverty of workers can decline even when wage inequality is increasing. Hanson (2006) compares wage distribution trends in the 1990s in Mexican regions that were most exposed to foreign direct investment and foreign trade with that in regions that were less exposed (after carefully excluding any effect of migration by high-ability migrants to regions with more opportunities). He finds that the number of wage-poor in states with high exposure declined by 10 percent relative to the number in nonexposed states. Arbache and others (2003), however, find that after the extensive trade liberalization in Brazil in the 1990s, average wages in the traded sector fell compared to the nontraded sector, even after adjusting for education, experience, and other factors. As for employment, analyzing a set of 25 trade liberalization episodes in developing countries using internationally comparable sectoral labor data, Seddon and Wacziarg (2004) conclude that trade liberalization has far smaller effects on intersectoral reallocation (even at the three-digit level of aggregation within manufacturing) than is conventionally presumed. More likely is that much of the structural change is intrasectoral and that some of the potential changes are neutralized by policies such as exchange-rate depreciation, labor regulations, and sector-specific subsidies.

The microstudies of the effects of trade reform in Mexico and Morocco by Revenga (1997), Feliciano (2001), and Currie and Harrison (1997) attribute the small effect on employment to labor regulations or to the firms' adjusting to trade reform by reducing their formerly protected profit margins and raising productivity rather than laying off workers. But even when the net effect on employment is relatively small, there may be considerable job reallocation and dislocation, as Levinsohn (1999) finds using firm-level data in Chile. Daveri and others (2003), using a sample of firms in six manufacturing sectors in India in 1997–9, confirm that employees of foreign-exposed (particularly exporting) firms face more wage and employment variability. At the same time, however, they have a higher probability of being trained and promoted than workers in firms that are not exposed to foreign competition. Comparing factories owned by multinational firms with domestic factories of the same size and efficiency in Indonesia, Bernard and Sjöholm (2003)

find that the probability of closure was 20 percent higher for the former over a 15-year period.

There are two recent microstudies that link trade liberalization and poverty. Between 1986 and 1994–5, the decline in urban poverty in Colombia coincided with drastic tariff reductions. In their statistical analysis, however, Goldberg and Pavcnik (2006) find that, across industries, trade liberalization either had no differential effect on poverty or, to the extent there was any effect, trade liberalization went in the direction of increasing poverty. The second study, by Topalova (2006), uses the difference-in-difference approach to show that in rural districts in India where exposure to the liberalization of the 1990s was concentrated (reduced agricultural tariffs were most relevant for rural districts), the incidence and depth of poverty increased as a result of trade liberalization—amounting to a setback of about 15 percent in India’s progress on poverty reduction. Both these studies suggest that limited labor mobility across industries in the former, and across districts in the latter, has something to do with the results.

2.2 The Causal Relations among Globalization, Wage Inequality, and Poverty

This section examines theoretical models that may shed some light on the causal processes (particularly in the wage labor market) possibly driving the observed relations of globalization, inequality, and poverty. First, there are models of wage inequality (or skill premium) designed to explain, from the viewpoint of Heckscher-Ohlin trade theory, why trade liberalization may have led to a rise in the skill premium in *both* rich (and presumably skill-abundant) and poor (and presumably skill-scarce) countries. The explanation most similar to the Heckscher-Ohlin model is that rich and poor countries are in different “cones of diversification” in the standard Lerner-Pearce diagram, so that there is no factor price equalization (see Davis, 1996). Suppose, for example, that there are two factors of production (skilled and unskilled labor), three countries, and three goods. The rich country—say, the United States—is in the cone where skilled labor is in relative abundance, and therefore specializes in the most skill-intensive good. By contrast, the two poor countries in the other cone are nearer the unskilled labor axis: one, say Mexico, is less skill-poor than the other, say China. In this case, China might specialize in the

least skill-intensive goods (textiles, for example) so that a reduction in tariffs in Mexico on these goods could increase wage inequality. This is because Mexico has an abundance of unskilled labor compared to the United States but an abundance of skilled labor compared to China. Trade liberalization between China and Mexico makes the relative factor price favorable to skilled labor in Mexico. The Heckscher-Ohlin distributional result thus applies to the two poor countries in the same cone of diversification.

It is interesting to note that, in this example, trade liberalization lowers tariffs in the most unskilled-labor-intensive sectors, such as textiles. This suggests that, possibly for political reasons (such as pressure from sectors employing large numbers of workers), preexisting tariffs—even in developing countries—were high not so much on skill-intensive import substitutes as on the most unskilled-labor-intensive goods. There is evidence of this kind of tariff structure for Mexico, Morocco, Brazil, and Colombia,¹² where unskilled-labor-intensive sectors were protected by the highest tariffs before trade reform and experienced the largest tariff reductions during trade reform.

Feenstra and Hanson (1996) offer a widely cited explanation of the rise in wage inequality in both rich and poor countries. Their study addresses U.S. outsourcing to Mexico through foreign investment, but its central idea is a continuum of goods ranked according to skill intensity, which is used to trace the effect of changes in output composition along the continuum on factor prices. At the boundary of specialization in this continuum are the most skill-intensive goods for Mexico and the least skill-intensive goods for the United States. As Mexico shifts the boundary to expand the range of goods and produce more skill-intensive products with foreign investment, the relative demand for more skilled labor increases; the same happens as the United States gives up its least skill-intensive goods, driving up the relative wage for skilled labor in both countries. Feenstra and Hanson give the example of the production of television sets shifting from the United States to the maquiladoras, starting with the chassis, then the electronic circuits, and then the picture tubes—going up the chain of skill intensity of production in Mexico.

Zhu and Trefler (2005) extend the model to a case without foreign investment but with a Ricardian source of comparative advantage added to

¹² See Harrison and Hanson (1999), Currie and Harrison (1997), Pavcnik and others (2004), and Attanasio and others (2004).

the advantage based on factor endowment. In their model, as the developing country catches up technologically, the production of the least skill-intensive goods in the rich country shifts to the developing country, where they become the most skill-intensive goods produced. Zhu and Trefler thus replicate the Feenstra-Hanson result and then empirically corroborate this particular causal mechanism. Xu (2003) also has a model with a continuum of goods (but neither foreign investment, as in the Feenstra-Hanson model, nor technology catch-up, as in the Zhu-Trefler model), wherein the boundary between traded and nontraded goods is endogenously determined by trade policy. He shows that trade liberalization can raise wage inequality by expanding the export portfolio of a developing country.

In most of these models, the rise in wage inequality is due to a shift in the relative demand for skilled labor across industries. Verhoogen (2004) has questioned this, at least with respect to the Mexican non-maquiladora sector. Contrary to the implications of the Feenstra-Hanson hypothesis, for example, he shows that maquiladoras are, on average, markedly *less* skill-intensive than the rest of the Mexican manufacturing sector. He focuses instead on trade-induced shifts within an industry, with firm heterogeneity and differential quality upgrading. When new trade opportunities arise—as in the case he examines, following the 1994 peso crisis—the most productive firms seize them and produce a better-quality good for export, raising returns on all factors in those firms.¹³ He confirms this with a panel data set on Mexican manufacturing plants.

Another set of explanations for the rise in wage inequality caused by globalization is related to trade-induced, skill-biased technical progress. Wood (1995) and Thoenig and Verdier (2003) suggest that some countries—both developing and rich—faced by competition from imports of cheap, unskilled, labor-intensive products from poorer countries may adopt skill-biased “defensive innovations.” Attanasio and others (2004) find some support for this in their study of Colombia. In the period 1984–98, the increase in demand for skilled workers was greatest in those sectors that experienced the large-

¹³ Verhoogen uses an O-ring production function in which the production of high-quality goods requires highly skilled workers across occupational categories and is more sensitive to the skill of white-collar workers than to that of blue-collar workers. Kremer and Maskin (2003) use their O-ring model to explain the coincidence of expanding trade and rising wage inequality in poor countries, but through matching workers from rich and poor countries in multinational firms rather than through the quality-upgrading mechanism emphasized by Verhoogen.

est tariff cuts (such as textiles and apparel). Acemoglu (2003) suggests that cheaper imports of machines, office equipment, and other capital goods that are complementary to skilled labor in developing countries provide the vehicle for skill-biased technical change. Harrison and Hanson (1999) find that across all Mexican industries in the 1980s, firms that imported machinery and materials were more likely to employ a higher share of white-collar workers than firms that did not. But Pavcnik (2003) cannot confirm this for Chilean plants in the early 1980s, controlling for time-invariant plant characteristics.

As noted earlier, a rise in wage inequality is compatible with a rise in absolute wage rate or wage income. Traditional international trade theory suggests that workers in poor countries (presumably with abundant supplies of unskilled labor) with a comparative advantage in products that are intensive in unskilled labor should benefit from trade liberalization. An obvious example is the improvement in wages and employment of garment workers (mostly women) in Bangladesh, Mauritius, or Vietnam as export sectors expanded. On the basis of household survey data, Hertel and others (2003) estimate that global trade liberalization leads—in the long run (that is, when labor and capital are mobile across sectors)—to a decline in poverty for all strata of the population. This is largely because increased demand for unskilled labor increases income, including for those who were formerly self-employed and have now moved into the wage labor market. Edmonds and Pavcnik (2003) also note how Vietnam's liberalization of the rice trade in the 1990s led to a beneficial reallocation of low-income labor from household occupations to the wage labor market.

There is not much theoretical literature showing that the wage income in a developing country can decline because of globalization, thus leading to a worsening of poverty. But this can happen, as the following suggest:

- In a three-country Heckscher-Ohlin-type model, the liberalization of Mexico's trade with the United States and China may lower the wage rate in Mexico. Similarly, in a Heckscher-Ohlin model, if a poor country has large supplies of nonlabor factors of production (such as land or mineral resources), trade liberalization may not benefit the labor-intensive sector.
- In the case of trade-induced (or a foreign-investor-introduced) and skill-biased technical change, it is possible for an extreme skill-biased change to lower the wage rate or employment of unskilled labor. Jhabvala and Kanbur (2004) give an example of how global tenders to construction

companies such as Bechtel or Mitsui, which use labor-saving technology, have led to the unemployment of many construction workers in India.

- If some factors of production are intersectorally immobile and some goods are nontraded, the real wage of an unskilled worker in a poor country may not rise with trade liberalization, even in an otherwise standard model of trade theory. Take a three-good model in a hypothetical African country: (i) a nontradable good (say, a subsistence food crop) largely grown by women who for various social and economic reasons cannot move to other sectors; (ii) another good (say, an exportable tree crop) produced largely by men in a capital-intensive way (perhaps simply because tree crops lock up capital for a long period); and (iii) the third good, say, an importable processed food that is possibly a substitute for the subsistence food. In this three-sector model, it is not difficult to show that the real wage of women may go down when the importable processed food is made cheaper by trade liberalization (under the sufficient condition that the elasticity of substitution in consumption of the two foods is sufficiently high). In general, lack of mobility is one of the most important issues in the link between trade and poverty—as has been suggested by the empirical work cited above by Goldberg and Pavcnik on urban Colombia and by Topalova on rural India. It is not clear, however, how much of the lack of mobility is due to rigid labor laws, as they suggest. Labor laws usually make it difficult to fire workers in import-competing industries, but do not prevent the absorption of labor in the expanding export industries (except indirectly, when the new employer keeps in mind the future difficulty of laying off new hires). For rural India, there are few labor laws. Displaced rural or urban workers cannot find replacement jobs easily because of severe credit market imperfections that hamper mobility, retraining, retooling, and so on.
- Take a two-period model where labor on a long-term contract is trained in the first period and the training bears fruit in the second period, when the long-contract workers are more productive than untrained short-contract, casual laborers. If opening the economy increases competition and raises the probability of a business failing, employers may hire short-contract, less productive, lower-wage laborers and bring down the average wage. On the other hand, increased foreign competition may lead to an exit of old, inefficient firms and the entry of new, more efficient firms, or to

a better allocation of resources within existing firms (for which there is plenty of evidence), thereby leading to a rise in average wages in industries that attain such a productivity gain.

- If firms facing more foreign competition and pressure to reduce costs outsource activities to smaller firms or to household enterprises in the informal sector, the average wage of those previously employed in the formal sector may fall, but this need not impoverish workers in general if the poorer informal workers acquire more employment this way.
- If the involvement of a large transnational company in a poor country's local labor market raises the employer monopsony power, wages (and employment) may fall. But there is little evidence that poor, unskilled workers earn lower wages (or find fewer jobs) when those companies are present, compared to what the workers get when such companies are absent, all other things being equal.¹⁴ Contrary to the impression created by the campaign in affluent countries against "sweatshops" run by transnational companies in poor countries, the poor are often eager to work in those sweatshops because their current alternative is much worse—to work in lower-income occupations, under worse conditions, or to be unemployed. This is not an argument against efforts to improve their working conditions (and it is certainly not in favor of the totally indefensible cases of forced labor or hazardous or unsafe working conditions).¹⁵ But it is an appeal to look at the severely limited opportunities of the poor and to realize that attempts to restrict rich-country imports of sweatshop products may, in fact, have the unintended consequence of displacing poor workers.

As foreign competition or its threat lowers profit margins, the old rent-sharing arrangements between employers and unionized workers come under pressure. Rents decline for both capital and labor, but labor may have to take a larger cut if, as has been argued, the increase in the (perceived) elasticity of demand in the product market (due to opening the economy to trade and

¹⁴ See, for example, Aitken and others (1996), Harrison and Scorse (2003), and Brown and others (2004).

¹⁵ Conceptually, a distinction should be made between unsafe or hazardous work conditions and forced labor on the one hand, and low-wage jobs on the other. Under capitalism, just as no workers should have the freedom to sell themselves, excessively unsafe working conditions that can cause bodily injury should also be strictly regulated. The case for stopping workers from accepting low-wage jobs is much weaker.

foreign investment) leads to an increase in the elasticity of demand for labor, lowering its bargaining power and generally weakening unions.¹⁶ This can lead to lower wages, and sometimes—even more important—to a greater risk of unemployment. Scheve and Slaughter (2002) show how the globalization of production through multinational enterprises, in particular, and related trade can make labor demand more elastic through increased product market competition and substitution of foreign factors of production, including intermediate inputs for domestic factors, thereby raising workers' economic insecurity. Even where the net effect on employment is relatively small, there may be considerable job reallocation and dislocation, as noted above.

Even when poor, unskilled workers lose from trade liberalization, it may be possible to combine a policy of trade liberalization with a domestic policy of compensating the losers at a low cost. Harrison and others (2003) have used a computable general equilibrium (CGE) model for Turkey to show with a numerical exercise that a direct income subsidy, financed by a value-added tax (VAT), is quite cost effective. The main problem, of course, is whether ruling politicians have a credible commitment that losers will be compensated. Recent history in many countries is full of reneged-on promises by governments to displaced workers. Obviously, this is particularly important in poor countries, where there is very little effective social protection available from the state. Rich countries have better social safety nets and programs to help displaced workers adjust. For example, the U.S. Federal Adjustment Assistance Program, strengthened by a 2002 act in Congress, while still quite inadequate, is meant to help displaced workers. Few, if any, poor countries have such programs. International organizations that preach the benefits of free trade should take responsibility for funding and facilitating such adjustment assistance programs in poor countries, so as to help workers cope with job losses, retrain, and get reemployed. There should be more income-support programs, such as the Trabajar initiative in Argentina, or programs to train

¹⁶ See Currie and Harrison (1997), Rodrik (1997), and Leamer (1998). The theoretical relation between product-market demand elasticity and the elasticity of derived demand for labor is somewhat more complex than usual in the case of imperfect competition and is not always clear-cut. There is scant empirical evidence in developing countries on the trade-induced changes in the elasticity of demand for labor. Krishna and others (2001) do not find much support for a positive effect of trade on labor demand elasticity on the basis of plant-level data in Turkey. Fajnzylber and others (2001), on the basis of plant-level data and taking account of both incumbent and exiting or entering firms, find very ambiguous effects of trade liberalization on wage elasticities in Chile and Colombia.

and help the unemployed find new jobs, such as the Probecat in Mexico. For a discussion of the effectiveness of different programs to help workers cope with job losses in Latin America, see World Bank (2000).

Until the general economic security of poor workers in developing countries is satisfactorily resolved, globalization is bound to raise anxiety and hostility among workers worried about job security. If mass politics in a country is organized in such a way that the nation or state is the main political forum for demanding and obtaining the necessary social redistributive and insurance functions (made more important by the economics of international specialization), then any weakening of the domestic economy by the forces of international economic integration is a matter of serious concern. Much depends, of course, on the institutions of conflict management and coordination. It is not a coincidence that countries with a better record of building these institutions have coped better with the dislocations provoked by international trade. The Scandinavian countries offer the prime example: despite a long and strong tradition of organized labor and worker solidarity over the last century, the unions have generally favored an open economy.

The weakening of the nation-state is a rather complex issue. When a poor country participates in international trade and investment in the framework of global institutions and their governing rules, it may lose some national policy options. The antiglobalization protesters correctly argue that many of the international organizations that define the rules of this order are accountable more to the corporate and financial communities of rich countries than to the poor, and that decision-making processes in these organizations need to be much more transparent and responsive to the lives of the people affected by their decisions.¹⁷ But the demand for the abolition of international organizations such as the World Trade Organization (WTO) is misplaced. If the alternative to a multilateral organization such as the WTO is for a developing country to face the United States in bilateral trade negotiations, the United States is likely to be much more dominant and arbitrary in such negotiations than are the dispensations of the WTO (which, in its arbitration decisions, has sometimes ruled against the United States). Serious efforts are clearly needed to strengthen the technical negotiating capacity of poor

¹⁷ In the World Trade Organization each member country has one vote and decisions are reached by "consensus." In the Bretton Woods institutions (the International Monetary Fund and the World Bank), voting is dollar-weighted.

countries in international trade forums, where they face well-equipped and well-funded teams of lawyers and negotiators representing rich countries.

The constraints on a national government's fiscal options in a global economy are thwarted, according to many, by the severely limited scope for taxing capital to raise revenue because of the long-term threat of capital flight, not to mention the short-term problem of speculative capital flows. (In fact, capital itself does not have to flee a country, since accounting practices and strategic bookkeeping adjustments often allow the base for capital taxes to migrate even when capital itself does not.) While this limitation can be serious, its effects should not be exaggerated. Most countries collect only a small part of their revenues from capital taxation, even in relatively closed economies. In any case, there are strong arguments for funding redistributive policies through progressive consumption taxes (VAT, for example) rather than taxes on capital or labor. There is clearly a need for tax coordination across countries, and there is some evidence that capital taxation is declining and converging across countries, but this should not be overstated. Even in the highly integrated European Union (EU), corporate tax rates have substantially converged—not to zero, as some people anticipated, but to about 35 percent. In general, between two equilibria—one with high taxes and high public-goods provision, and the other with low taxes and low public goods—capital need not choose the latter over the former. For most medium to large countries, the adverse effects of globalization on the political viability of national-level redistributive practices and institutions are somewhat exaggerated.¹⁸

2.3 The Self-Employed Poor and the Poor as Consumers

In addition to wage laborers, there are vast numbers of self-employed poor. The self-employed work on their own tiny farms or as artisans and small entrepreneurs in small shops and household enterprises. The major constraints they usually face are in credit, marketing, insurance, infrastructure (roads, power, extension service, and irrigation), and government regulations (venal inspectors, insecure land rights, and so on). These often require substantive changes in domestic policy and governance; foreign traders and investors are

¹⁸ For a detailed discussion of the relevant political economy issues on this question, see Bardhan and others (2006).

not directly to blame. If these changes are not made and the self-employed poor remain constrained, then it is difficult for them to withstand competition from large agribusinesses or firms (foreign or domestic).

Two examples are pertinent here. Using panel data for farm households in Zambia, Deininger and Olinto (2000) show that many households could not reap productivity benefits from external liberalization because they lacked key assets such as draft animals and farm implements. Similarly, López and others (1995) show from panel data on farm households in Mexico that the supply response to price incentives is much lower for households with more limited access to capital. Opening the product markets internationally without doing anything about the weak or distorted factor markets, such as credit or infrastructural services, may thus be a suboptimal and even disastrous policy for many poor farmers and artisans, from the viewpoint both of exploiting new opportunities and of social protection for those who may need extra help to cope.

Measuring the direct impact of trade reform on the poverty of the self-employed is tricky. In addition to the scarcity of detailed household data before and after trade reforms, it is often difficult to disentangle the effects of trade reform from those of other reforms, events, and shocks that affect the poverty dynamics of the household. Most existing measurement attempts use simulation models. The study by Litchfield and others (2003) is among the first empirical attempts using household survey data for more than one period. For Vietnam in the 1990s, for example, these authors find in a multinomial logit model that the trade variables have a positive, significant effect on a household's chance of escaping poverty.

It is not hard to see that openness to foreign trade and investment may sometimes help relieve some of the bottlenecks in infrastructure and services, as well as in essential parts, components, and other intermediate products such as fertilizers and pesticides. Gisselquist and Grether (2000) show how farmers in Bangladesh benefited as liberalization increased the availability of farm inputs. In a more general sense, the international diffusion of technology in agriculture, of which the Green Revolution has been a dramatic example, has led to large reductions in poverty, particularly in Asia, even though farm households became more dependent on purchased inputs that were necessary but that increased the importance of the credit and irrigation constraints.

Small farms or firms that are not severely handicapped by credit and other constraints are sometimes more productive than their larger counterparts

and also occasionally more successful in export markets. Small producers are often heavily involved in exports, such as coffee producers in Uganda or Nicaragua, rice growers in Vietnam, shrimp farmers in coastal Bangladesh or India, and garment producers in Bangladesh or Cambodia. But in exports, the major hurdle often springs from less rather than more globalization. Developed country protectionism, as well as subsidized farm and food products and simple manufactures (such as textiles and clothing), severely restrict poor countries' export prospects.¹⁹ World Bank estimates, based on the Global Trade Analysis Project (GTAP) model, show that developing countries lose about \$24 billion in income because of rich-country trade barriers on textiles and apparel. Taking tariffs and tariff-equivalents of subsidies in agriculture, Cline (2004) estimates that the overall protection in agriculture is about 20 percent for the United States, 46 percent for the EU,²⁰ 52 percent for Canada, and 82 percent for Japan. Cline further calculates an annual loss of about \$45 billion (and much higher if dynamic effects are taken into account) for developing countries from agricultural tariffs and subsidies in rich countries from a static CGE model and the GTAP trade and protection database.

Antiglobal protesters in rich countries might well turn their energies toward the vested interests in their own countries that support protectionism and cripple the efforts of the world's poor to climb out of their poverty. Propoor opponents of the North American Free Trade Agreement (NAFTA), for example, point out how competition from Northern agribusiness is destroying the livelihoods of small farmers in Mexico; they are less vocal about the farm subsidies and tariffs in the United States and Canada that to a large extent are responsible for this. U.S. wheat export prices are estimated to be 46 percent below the cost of production, the price of corn exports are 20 percent below cost, and so on.²¹ It is not surprising that U.S. cotton subsidies provided a major flash point in the breakdown of the WTO ministerial negotiations in

¹⁹ This is not to minimize the trade barriers imposed by developing countries on imports of other developing countries, which are often higher than those imposed by rich countries. There are some conflicting estimates of the welfare gains of the reduction in trade barriers imposed by developing countries themselves, relative to that for the reduction in trade barriers imposed by industrial countries. A convincing estimate by Cline (2004) suggests that industrial-country liberalization provides from about half to two-thirds of the total potential welfare gains to developing countries from trade liberalization all around.

²⁰ Adjusting for the preferential entry of farm products from some countries, the agricultural protection for the European Union goes down to 34.5 percent.

²¹ See, for example, Oxfam (2002).

Cancún in September 2003, since this crop is grown by farmers in some of the poorest countries of the world.²² This is not to minimize the responsibility of domestic governments. In Mexico, for example, following the peso crisis of 1994, the government abandoned its plans to phase in trade liberalization. While the Procampo program provided some compensation to very poor farmers against the price decline, no public support infrastructure allowed small farmers to adjust to the new patterns of production so that they could be competitive after NAFTA entered into force.

Many small farmers of developing countries face another increasingly significant barrier to trade in world markets: the host of safety and sanitary regulations, sometimes imposed under pressure from lobbyists working for import-competing firms that wealthy countries now use to shut out many imports. This may actually increase the need to involve rich-country transnational companies in marketing poor-country products. These companies can deal far better with the regulatory and lobbying machinery in rich countries than can small producers from poor countries, while also providing consumers with credible guarantees of quality and safety. Such firms will charge hefty fees for this marketing service (usually much larger than the total production cost) and sometimes impose costs that small farmers will find burdensome. European supermarkets, for example, now insist that farmers meet health and safety rules, and that they undertake product testing, farm audits, and staff training. It has been pointed out that farm audits alone cost around \$500 per farmer, more than many farmers earn in the supplying countries in Africa. In some cases the retail chains' tighter control over suppliers, in an effort to ensure standards and practices, has led to a drastic decline in the proportion of exports from small holders (for an example from Kenyan horticulture exports, see Dolan and Sutherland, 2002).

Similarly, it may be very difficult, costly, and time consuming for small producers of manufactures or services in developing countries to establish a brand name and reputation for quality and timely delivery, which are absolutely crucial in marketing, particularly in international markets (much more than the comparative costs of production that traditional trade theory

²² In a study of Benin, Minot and Daniels (2002) show that a 40 percent reduction in farm gate cotton prices, equivalent to the price decline between December 2000 and May 2002, implies an 8 percent reduction in per capita income in the short run (6–7 percent in the long run), with the incidence of poverty among cotton growers rising in the short run from 37 percent to 59 percent.

emphasizes). This is where multinational marketing chains with global brand names, mediating between domestic suppliers and foreign buyers, will play a dominant role for a long time, and small producers can do worse than to pay their high marketing margin. The priority should be to coordinate attempts by developing countries, with technical and financial assistance from international organizations, to build international quality certification institutions and domestic cooperative marketing organizations for their products.

There is very little hard empirical evidence on the precise figures of marketing margins. There are occasional newspaper reports—for example, that a 44-pound box of bananas sells for about \$25 in U.S. supermarkets while producers in Ecuador get only \$2 or \$3.²³ There are similar reports that a shirt for which the Hong Kong producer gets less than \$1 sells for at least \$20 in Gap stores in the United States. Much of the difference is accounted for by transport, distribution, and inventory costs, but the marketing margins are likely to be substantial. Morisset (1998) points out that the spread between world and domestic prices almost doubled over 1975–94 in all major commodity markets, leading to the loss of several billions of dollars of potential revenue for commodity-exporting countries. He suggests that the market power of international trading companies could be the major reason, after showing why changes in trade and tax policies or factors such as transport, processing, and market costs cannot provide a systematic explanation.

The examples of two major beverage markets, coffee and tea, are also pertinent. Four transnational retail companies dominate the coffee market. In the early 1990s, coffee-exporting countries earned \$10 to \$12 billion for retail sales of approximately \$30 billion. While retail sales had more than doubled by 2002, coffee-producing countries earned about half of what they had earned a decade earlier. Three companies control more than 80 percent of the world tea market. Many in the tea industry in India believe that the cartels of the big buying companies repress prices on the tea auction floors. A 2003 report in Delhi states that while the tea price in the retail market was around Rs 160 per kilogram, it was less than Rs 50 per kilogram in the auctions; while auction prices have fallen, retail prices of tea continue to rise.

²³ Similarly, there are reports that in the United Kingdom, for every £1 that shoppers spend on loose Ecuadorian bananas, around 40 pence goes to supermarkets while plantation workers receive just 1.5 pence. See www.bananalink.org.uk/tuforum/split.htm. Five companies control over 80 percent of the global market.

In recent years, mergers, acquisitions, and business alliances have enabled the agrifood corporations to concentrate enormous market power. Companies such as Monsanto, Cargill, Nestlé, and Wal-Mart have come to dominate supply chains for food and agricultural goods from seed to supermarket shelf. Five companies control 90 percent of the world grain trade; six corporations control three-quarters of the global pesticides market; Wal-Mart controls 40 percent of Mexico's retail sector; Nestlé has established a virtual monopoly over the ultrahigh-temperature milk market in Pakistan and controls around 80 percent of Peru's milk production; DuPont and Monsanto dominate the world seed markets for corn (65 percent) and soy (44 percent).²⁴

Those who are justifiably outraged by the extremely high marketing margins that the monopoly multinational companies currently charge poor producers, by their price-fixing cartels or by their efforts to push out small producers from the supply chains, should agitate for antitrust action rather than against trade. There should also be more energetic international attempts to certify codes against international restrictive business practices and to establish an international antitrust investigation agency, possibly under the auspices of the WTO. Even if such an agency might not have much enforcement power, internationally publicized reports of antitrust investigations by a recognized international body will have some impact on rapacious monopolies and strengthen the hands of domestic competition commissions in developing countries.

Trade liberalization, even when increasing the mean incomes of the poor, may heighten their vulnerability, particularly by increasing the variance of prices or income sources. Theoretically there can be conflicting factors working here, and whether variability increases in a particular case can be resolved only empirically. Winters and others (2004) give a brief summary of the empirical literature on this question and cite a study of how trade liberalization may have helped mitigate the postflood food crisis in Bangladesh in 1998, with private imports stabilizing prices. They also cite evidence from Côte d'Ivoire that the end of domestic marketing arrangements with liberalization may have increased the price variance. There is general agreement on the poor's limited capacity to cope with negative price and income shocks.

²⁴ Much of the information in this paragraph comes from a summary report by Action Aid International (2005) that cites the original sources.

Commodity concentration of exports is another issue. More than 50 developing countries depend on three or fewer primary commodities for more than half of their exports. Exports of such products are often a curse as well as a blessing, because their prices fluctuate wildly and the economy is too dependent on them. As a result of the recent elimination of inefficiently run marketing boards and the dismantling of wasteful stabilization schemes, farmers in many African countries now receive a higher fraction²⁵ of a more volatile (and in some cases, lower) world market price.²⁶ International commodity agreements among these countries to control the supply of the goods in the world market have not worked very well in the past. Probably the best way to reduce economic vulnerability is to diversify production and promote skill formation, gradually moving up the supply chain toward activities with more value addition for the same commodity while arranging insurance for farmers in poor countries at an international level. As suggested above, however, the transnational corporate concentration in some of the higher-value stages of the supply chain imposes formidable barriers to entry.

When economies open, export crops benefit from new opportunities that could potentially lift producers out of poverty. At the same time, crops of countries with little comparative advantage will lose out, pushing small producers into poverty, if there is a pervasive failure of credit and insurance markets and no vigorous program of public adjustment assistance and extension services to help producers reallocate their resources. The poor growers of traditional crops are often ill-equipped to shift, unaided, to new commercial products such as fruits, vegetables, flowers, dairy products, processed foods, and so on. These products require new storage and transport infrastructure, large setup costs, marketing connections, and new legal rules and institutional structures that can facilitate contract farming and agroprocessing in a way that does not expose small producers to exploitation by large marketing chains. This is not an argument against globalization, but rather for proactive public programs to help poor farmers adjust and coordinate. International agencies that advocate the benefits of free trade have an obligation to provide financial, organizational, and technical assistance for such programs.

The remarks about self-employed farmers are also largely valid for self-employed workers in nonagricultural activities. Some firms adjust well to new

²⁵ Unless private marketing cartels replace the public monopsony.

²⁶ See Gilbert and Varangis (2003) for the case of cocoa. For a range of crops in Africa, see Townsend (1999).

trade opportunities, but others find it difficult to cope with the competition, depending on their initial asset, credit, and other infrastructural conditions. Parker and others (1995), in their study of small enterprises in five African countries, show that firms that adapted quickly benefited from import liberalization while those ill-prepared to face competition lost out. What is needed, therefore, is for liberalization to be accompanied by a comprehensive policy package—to enhance the capability of the ill-prepared firms—and a safety net for people who lose in the process.

The issue of child labor has attracted a great deal of international attention in connection with debates on globalization. Contrary to popular impressions in the West, most children working in poor countries work for their family enterprises. Edmonds and Pavcnik (2005b) tabulated detailed household surveys—coordinated by the United Nations Children’s Fund (UNICEF)—of 36 low-income countries with 124 million children aged 5–14. They show that 25 percent of these children work in gainful employment but less than 3 percent work outside their family enterprises for pay. About 70 percent of the children attend school. Of those who do not, only about a quarter work on what can be at least partially described as gainful work (including in family enterprises); the rest of those who do not attend school either do not work or do only domestic chores. Theoretically, the trade-induced expansion of an industry that employs children may increase the demand for child (and adult) labor, but the resultant income effect will reduce the supply of child labor from poor (or credit-constrained) households. Edmonds and Pavcnik (2005a) study the effect of national and international rice market liberalization in rural Vietnam in the 1990s on the basis of household survey data. They find that the income effect dominates: an increase of 30 percent in the real price of rice in this period is associated with a 9.2 percent decline in the probability that a child works. The result might have been different in a country where most of the poor are net rice consumers, but the point remains that a policy that increases earning opportunities for poor households (rather than well-intentioned but simplistic punitive policies, such as boycotting products produced with child labor) is much more effective in reducing child labor. Particularly effective have been intervention programs contingent on school attendance, such as Progresá in Mexico (now expanded into the Oportunidades program) or the Food for Education Program in Bangladesh.

What of the poor as consumers? Whether they gain as consumers from trade depends on whether they are net buyers of tradable goods. For example,

the landless laborers in East or South India who are net buyers of rice may gain from imports of cheaper rice from Thailand. But they may lose from higher medicine prices as the Indian drug market becomes internationalized: the laws changed in 2005 from recognizing only process patents to the international product patent system under the Agreement on Trade-Related Aspects of International Property Rights. Or they may lose because of the degree to which the retail market structure is monopolistic and blocks the pass-through from border prices to domestic prices: in Mexico after NAFTA, for example, the cartelized tortilla sector largely maintained prices even though cheaper North American corn was available.

In one of the most disaggregated exercises in the empirical literature, Ravallion and Lokshin (2004), using Morocco's household survey of living standards and a general-equilibrium simulation of trade policy change, show that a simulated trade reform in the form of liberalization of cereal imports in Morocco (which does not have a comparative advantage in water-intensive cereals production) leads to a rise in rural poverty where the losses to the net producers of cereals outweigh the gains to the net consumers among the poor. In an application of a general-equilibrium formulation of the effect of trade policy, Porto (2003) examines the impact on urban households of Argentina's entry into the Southern Common Market. He finds that the poverty decline through the labor income channel (the usual Stolper-Samuelson effect) outweighs any negative consumption effect. Before generalizing these findings, one should recognize that much depends on where trade liberalization lowers prices (for example, in agricultural or manufactured goods), the nature of price response to trade policy, various price elasticities and factor intensities in production, and the demographics and location of the poor (rural or urban).

Whether developing countries are net importers or exporters of agricultural products varies a great deal from country to country. Valdes and McCalla (2004), using data from the Food and Agriculture Organization, estimate that of the 115 low-income and low-middle-income countries, 62 are net agricultural-good-importing countries and 53 are net agricultural-good-exporting countries. In general, with the expected price rise from agricultural trade liberalization in the form of reduced agricultural tariffs and subsidies in developed countries, the former set of countries is likely to lose and the latter to gain. Contrary to the impression given by advocates of agricultural trade liberalization, many poor countries will not gain from this lib-

eralization.²⁷ In particular, of the 46 countries classified by the United Nations as least developed, 30 are net agricultural-good-importing countries.²⁸ It is unlikely that liberalization will transform some of them into large agricultural-good-exporting countries. Even in the case of the less numerous agricultural-good-exporting least developed countries, many are likely to lose their special preferential status under the current regime in some developed markets. For example, many least developed countries in Africa have duty- and quota-free access to the EU market, where they currently sell at the EU's high internal prices. This does not apply to the recently publicized case of poor countries exporting cotton, since the highest domestic subsidies (depressing world price) are in the United States.

2.4 The Poor as Users of Public and Environmental Resources

In low-income developing countries the poor, especially those in the informal sector, receive little effective social protection from the state, although the public sector is usually involved in basic services such as education, health care, and public works programs. Cuts in public budgets for these basic services are often attributed to globalization, since they often come as part of a package of macroeconomic stabilization prescribed by international agencies such as the International Monetary Fund. Trade reforms can bring about a decline in customs revenue (which is usually a substantial source of total government revenue in low-income countries) because of tariff cuts, to the extent that these are not offset by the replacement of preexisting quotas with tariffs. But when Pritchett and Sethi (1994) analyzed the tariff-reduction experiences of Jamaica, Kenya, and Pakistan, they found that revenues often fell substantially less than tariff rates. Much depends on the nature of the customs administration, the complexity of the tariff structure, and the scope for expansion of the revenue base following trade reform.

There is certainly much scope for improving the internationally prescribed (and occasionally ideologically blinkered) stabilization programs, so as to minimize their adverse impact on the poor. But it is always convenient to

²⁷ See Panagariya (2004).

²⁸ In terms of population, roughly one-fifth of the total population of these least developed countries is in one country, Bangladesh, which is a net importer of agricultural goods.

blame an external agency for a problem that is essentially domestic in origin: it must be recalled that fiscal deficits in these poor countries are often created more by domestic profligacy in the form of subsidies to the rich, salaries for the bloated public sector, or military extravagance. Faced with mounting fiscal deficits, the governments often find it politically more expedient to cut public expenditures for the voiceless poor (along with public investment programs), mainly because of the domestic political clout of the rich, who are disinclined to share in the necessary fiscal austerity.

The poor quality and modest quantity of public services such as education and health care in poor countries stems not only from their relatively low share of the public budget. To a large extent, even the limited budgetary allocations do not reach the poor because of many top-heavy administrative obstacles, as well as bureaucratic and political corruption. The development literature is full of accounts of targeting failures in social expenditures.²⁹ Again, this is a failure of domestic institutions rather than a largely external problem. The major effort required here is to strengthen the domestic institutions of accountability.

In addition to basic public services, the poor also use common property resources. The decline in common property resources is not usually taken into account in the standard estimates of poverty, since these estimates are based either on household surveys of private consumer expenditure or on national income accounts. Environmentalists argue that trade liberalization damages the poor by encouraging overexploitation of fragile environmental resources (forestry, fishery, surface- and groundwater irrigation, grazing lands, and so forth) on which the rural poor crucially depend. The answers are actually complex: mere trade restriction is not the solution. The environmental effects of trade liberalization on the rural economy depend on the crop pattern and methods of production. Take, for example, an African rural economy where the exportable product is a capital-intensive tree crop such as coffee or cocoa, the import-substitute is a land-intensive crop such as maize, and there is a labor-intensive subsistence (nontraded) crop such as roots and tubers. The economy may have a comparative advantage in tree crops. In this case, under a trade-protection regime an increase in import substitution leads to an expansion of cultivated land under the land-intensive crop and a shortening of the fallow period, causing deple-

²⁹ See Lanjouw and Ravallion (1999).

tion of natural vegetation and biomass. Trade liberalization in this context encourages the production of the less land-intensive tree crop and can significantly improve the natural biomass. This has been shown by López (2000) for Côte d'Ivoire in the latter part of the 1980s, using data from the Living Standards Survey and some remote sensing data from satellite images. There are, of course, some cases where international trade may push a country into a narrow range of crop specialization, when the subsequent loss of diversity may reduce the resilience of the local ecosystem and make it more vulnerable to shocks.

One reason why land-intensive crops may lead to an overuse of land and the depletion of natural vegetation (or why expansion of the agricultural frontier in general leads to deforestation) is the lack of well-defined property rights or their enforcement in public or communal land. In such cases, the private cost of expanding production is lower than the social cost and there is an overuse and degradation of environmental resources. If the country exports such resource-intensive products, foreign trade may worsen this misallocation. International trade theorists point out that trade restriction is not the best policy in this situation; correcting the property rights regime—including community-based regulations and coordination—is.³⁰ This involves significant changes in the legal-regulatory or community institutional framework that take a long time to implement. Given the threshold effects and irreversibility of environmental degradation (forest regeneration requires a minimum stock, for example), one cannot afford to wait. A program of (time-bound) trade restriction, coupled with serious attempts to overhaul the domestic institutional framework, may be necessary. In some cases of international disputes, such as sea turtles being caught in the nets of fishermen in developing countries, international assistance in providing turtle-excluder devices is much cheaper than trade restrictions for all concerned. In other cases, domestic policy changes can be implemented quite quickly, and restricting trade is unnecessary and undesirable. When coastal shrimp ponds in a shrimp-exporting country such as India or Bangladesh pollute the water supply and destroy surrounding mangroves, for example, domestic taxes based on the “polluter pays” principle are imperative. In some cases, domestic government policies are mainly responsible for environmental degradation.

³⁰ Note that traditional local community regulations sometimes become less viable with more market integration, as social norms erode and the exit options of community members improve.

For example, administered underpricing of precious environmental resources (irrigation water in India, energy in Russia, timber concessions in Indonesia and the Philippines, and so on), prolonged by pressure from powerful political lobbies, is a major cause of resource depletion. Domestic, vested interests rather than globalization are responsible for the persistence of these socially damaging policies.

For some resource-intensive exports, a country may be unable to adopt environmental regulations if its international competitors do not adopt them at the same time and thus remain able to undercut the regulated country in international markets. Here there is an obvious need for coordinating the environmental-regulation policies of the countries concerned. Given the low elasticity of demand for many resource-intensive, primary-export commodities from developing countries in the world market, such coordinated policies can raise prices and the terms of trade without leading to a decline in export revenue.³¹

A common charge against multinational companies is that they flock to developing country “pollution havens” to take advantage of lax environmental standards. In one of the very few careful empirical studies of the question, Eskeland and Harrison (2003) examine the pattern of foreign investment in Mexico, Venezuela, Morocco, and Côte d’Ivoire. They find no evidence that foreign investment in these countries is related to pollution abatement costs in rich countries. They also find that within a given industry, foreign plants are significantly more energy efficient and use cleaner types of energy than their local peers.

2.5 Policies to Alleviate Poverty without Relinquishing the Gains of Globalization

In general, globalization—understood here as opening an economy to trade and long-term capital flows—can constrain some policy options and eliminate some jobs and entrepreneurial opportunities for the poor and for small

³¹ Repetto (1995) puts together the estimates of world elasticity of demand for some of the natural-resource-intensive export commodities of developing countries. For the eight commercial agricultural commodities he considers, the absolute value of the elasticity does not exceed 0.5: in the case of tropical timber it is 0.16; for nonconifer logs, 0.74; for nonconifer sawed wood and for nonconifer plywood, 1.14.

enterprises. But in the medium to long term it need not make the poor, as a whole, much worse off if appropriate domestic policies and institutions (particularly for support infrastructure to help production reorganization, labor-market adjustment, and social protection) are in place and if appropriate coordination among the involved parties can be organized. Societies with institutions that can better coordinate social protection and economic restructuring, and that can ensure that the winners share some of their gains with the losers, are better placed to cope with the turbulence that globalization necessarily involves. If the institutional prerequisites can be managed, globalization opens the door for some new opportunities, even for the poor. Domestic institutional reform is not easy, however, and requires political leadership, popular participation, and administrative capacity that are often lacking in poor countries. If the focus remains on agitating against transnational companies and international organizations such as the WTO, attention is often diverted from the vested interests of domestic institutions and the time for challenging them politically is postponed. In some cases, opening the economy may unleash forces for this challenge. Some suggest that in countries with long-entrenched oligarchic structures, international exposure may undermine those structures.³² Global competition among nation-states, and the transmission of ideas and information, improve all citizens' ability to compare institutional performance across countries. This may bring about improvements in the accountability of governance institutions dominated by the elite.

As in the debates over "dependency" theories in development sociology several decades ago, there is often a tendency to attribute many of the problems of underdevelopment to the inexorable forces of the international economic and political order and to ignore the power of domestic vested interests. Poverty alleviation in the form of expanded credit and marketing facilities; land reform or public works programs for the unemployed; or the provision of basic education, training, and health care need not be blocked by the forces of globalization in many countries—particularly medium-sized to large countries that are home to most of the world's poor. Substantial though

³² Diaz-Cayers and others (2000) suggest that in Mexico the post-NAFTA exposure to international trade and investment may have helped bring about the erosion of support for the long-dominant Institutional Revolutionary Party. López-Córdova and Meissner (2005) find a positive effect of international trade on democracy in a statistical analysis across countries since 1895.

necessarily time-bound income-support programs, coupled with retraining and extension facilities for displaced workers or distressed farmers and small producers, are essential to relieve the obvious anxieties about economic insecurity generated by globalization. This requires a restructuring of existing budget priorities and a better, more accountable political and administrative framework. The obstacles to these are often largely domestic. Closing the economy does not reduce the power of the vested interests: landlords, corrupt or inept politicians and bureaucrats, and the currently subsidized rich. The poverty-alleviation measures mentioned above are not merely redistributive; they also enhance the productivity of workers and farmers and hence need not come at the expense of the global competitiveness of a country's products. All of this means that, contrary to the claims made by critics of globalization, the phenomenon is often not the main cause of developing countries' problems—just as globalization, contrary to the claims of some overenthusiastic free traders, is often not the main solution.

None of this absolves international organizations and entities of responsibility for helping the world's poor. They can do this by:

- Working toward a reduction of rich-country protection on goods produced by the poor
- Energetic antitrust actions to challenge the monopoly power of international (producing and trading) companies based in rich countries
- Facilitating international partnerships in research and development for products (for example, drugs, vaccines, crops) suitable for the poor
- Organizing more substantial and more effectively governed financial and technology transfers and international adjustment assistance for displaced workers and farmers
- Building the legal and technical capacity of poor countries in international negotiations
- Supporting certification organizations for their products in international markets

Many of these policies allow a great deal of scope for public-private partnerships. The international partnership to start a global fund to fight some of the killer diseases of the poor (malaria, tuberculosis, AIDS) is quite active among private foundations such as the Gates Foundation, nongovernmental organizations (NGOs) such as Médecins sans Frontières, international in-

stitutions such as the World Health Organization and the World Bank, and donor-country governments. Note also the 1997 Partners' Agreement to Eliminate Child Labor in the Soccer Ball Industry in Pakistan (which produces a large share of the world's soccer balls), whereby transnational sporting goods companies, the Pakistan Chamber of Commerce, the International Labour Organization, and some NGOs reached an agreement to eliminate child labor in that industry, provide scholarships to the displaced children, arrange for needed school facilities, and monitor the agreement.³³ Oxfam, a major NGO, has already proposed an international antitrust body under the auspices of the WTO. Even without enforcement powers, well-publicized accounts of investigations carried out by such a body can be effective in curbing some of the monopoly practices of transnational companies that consume a large part of the conventional gains from trade for a developing country. A recent case brought by an NGO, the Treatment Action Campaign, against some transnational pharmaceutical companies for their excessive pricing of patented antiretrovirals with the South African Competition Commission led the companies to settle for licensing generic production. As mentioned above, an international quality-certification organization established through a public-private partnership can help poor countries establish a brand-name reputation for their products and add to their market value. A fair-trade coffee movement is slowly showing some effect in raising the prices received by small coffee farmers (though as yet this accounts for, at most, 3 percent of total coffee sales). Britain's Department for International Development has started small-scale assistance programs for workers displaced from bankrupt firms, in collaboration with local NGOs in some poor countries. These are all small steps on a road well worth taking, without forgetting the need for constant and careful evaluation of their effectiveness.

Finally, the following are suggestions for potentially fruitful research on the topic of globalization, inequality, and poverty:

- Microstudies of the interaction between trade policy and labor market institutions. In particular, household surveys need to be integrated with surveys of worker characteristics, worker displacement and unemployment, and the identities of the firms from which workers are displaced and those where jobs are sought. These studies should be at a sufficient

³³ See IPEC (1999).

level of sectoral disaggregation and should address institutional specifications such as the involvement of unions, the degree of informality, or access to any kinds of adjustment assistance.

- Work at the plant or firm level on the interaction between trade policy and technical change or quality upgrading, and the link with changes in income distribution.
- If lack of labor mobility is at the root of the link between trade liberalization and poverty, there is a need for studies to determine if this is mainly the effect of imperfections in the credit market or of rigidities in formal sector labor laws.
- Detailed evaluations of the few programs in some developing countries to help trade-displaced workers (reportedly, adjustment-assistance policies have not been very successful in the United States).
- Case studies of how global competition (or its opposite through mergers and acquisitions) affects the monopoly practices of transnational companies and retail market chains, particularly with respect to the hefty margins charged for marketing the products of developing countries under international brand names. It is curious how little of the vast international trade literature is devoted to understanding the operations of international trading companies and the pattern and source of their market power.
- Micro case studies (as opposed to anecdotes or much too aggregative cross-country exercises) to understand how opening an economy affects the domestic political equilibrium and shapes state policies toward poor farmers and workers.

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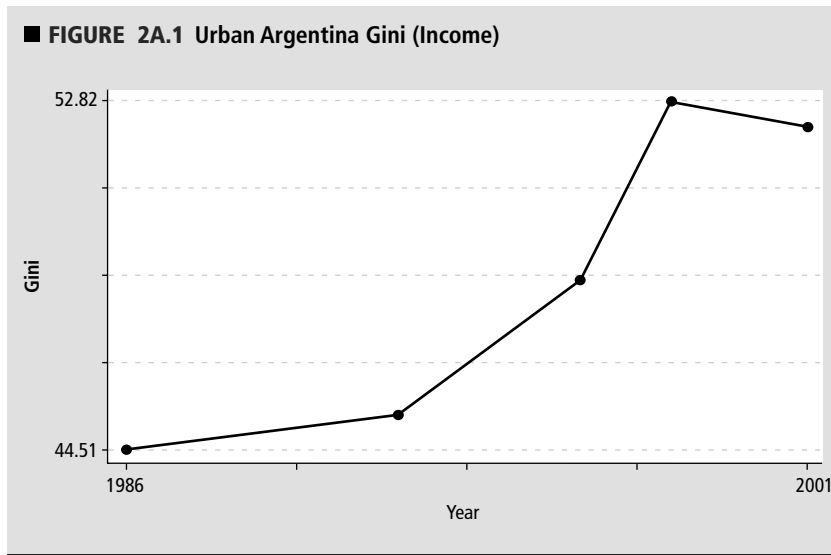
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APPENDIX 2.1

Time Series Graphs of Gini Coefficients for 10 Countries

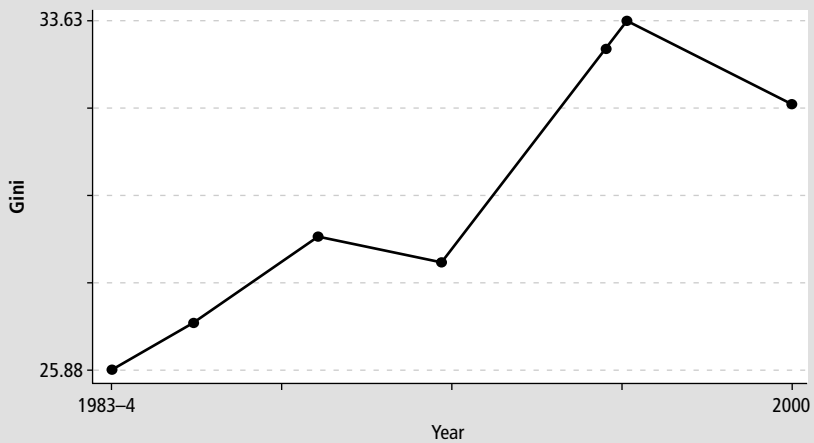
All data come from the World Bank's Povcal database. In most cases, the Gini coefficients were computed with household surveys using expenditure or income per capita. Data type is income or expenditure as indicated in the figure titles. For more information about this data set, see Chen and Ravallion (2004).



Source: World Bank Povcal database.

Note: Data-type information missing for the 1986 Gini is assumed to be income.

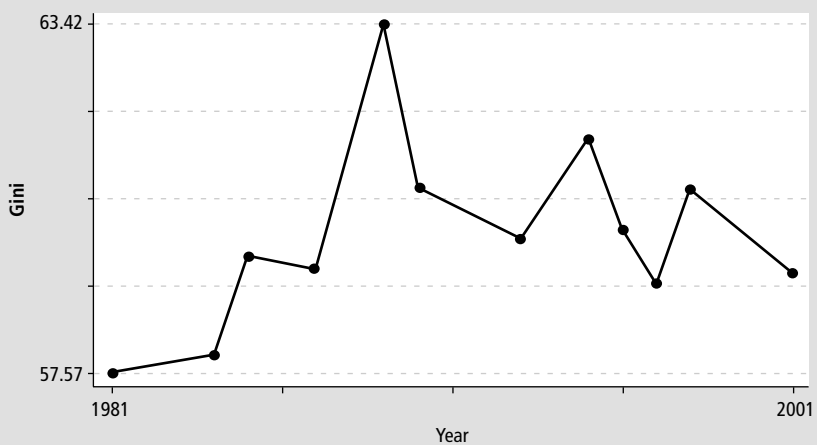
■ FIGURE 2A.2 Bangladesh Gini (Expenditure)



Source: World Bank Povcal database.

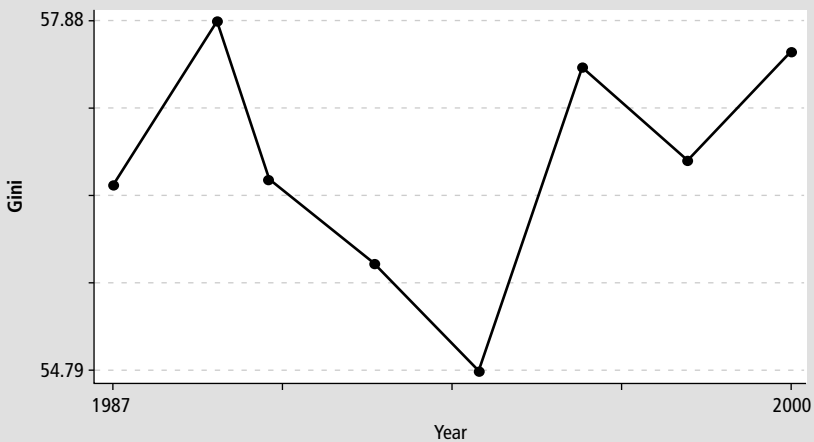
Note: Data-type information missing for the 1995-6 Gini is assumed to be expenditure.

■ FIGURE 2A.3 Brazil Gini (Income)



Source: World Bank Povcal database.

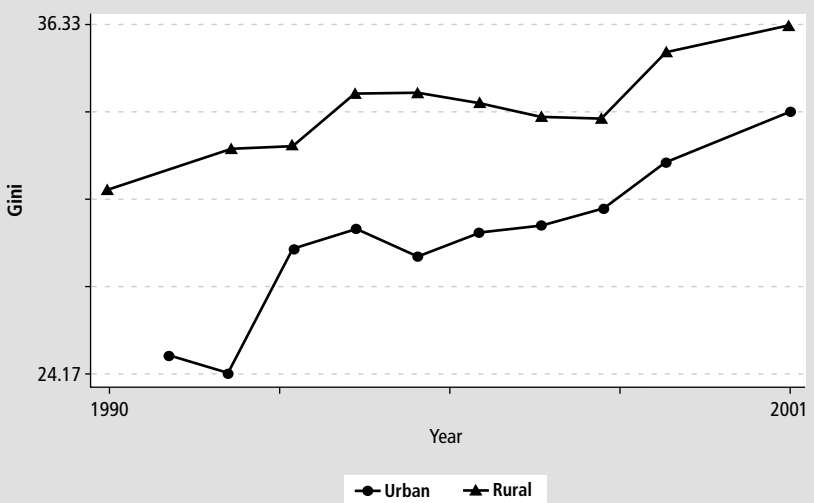
■ FIGURE 2A.4 Chile Gini (Income)



Source: World Bank Povcal database.

Note: Data-type information missing for the 1989 and 2000 Ginis is assumed to be income.

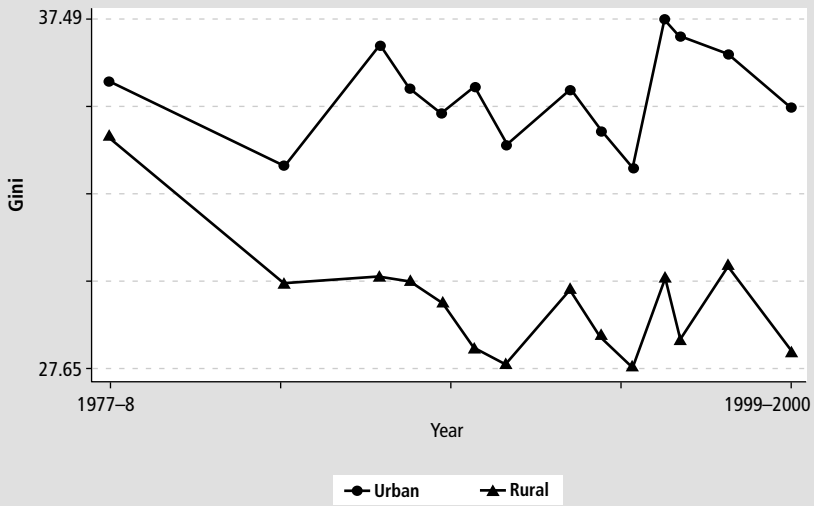
■ FIGURE 2A.5 China Gini (Expenditure)



Source: World Bank Povcal database.

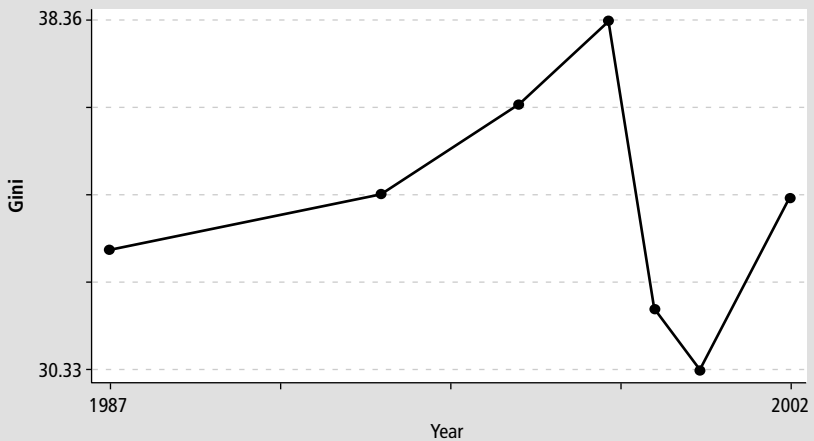
Note: Ginis for 1992, 1993, 1996, 1999, and 2001 are computed using expenditure data. Remaining coefficients are also computed with expenditure data based on Chen and Ravallion (2004).

■ FIGURE 2A.6 India Gini (Expenditure)



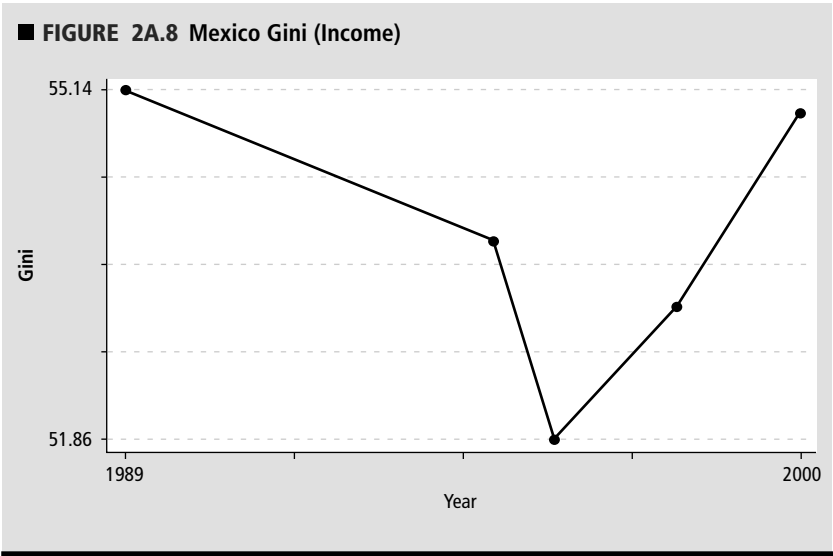
Source: World Bank Povcal database.

■ FIGURE 2A.7 Indonesia Gini (Expenditure)

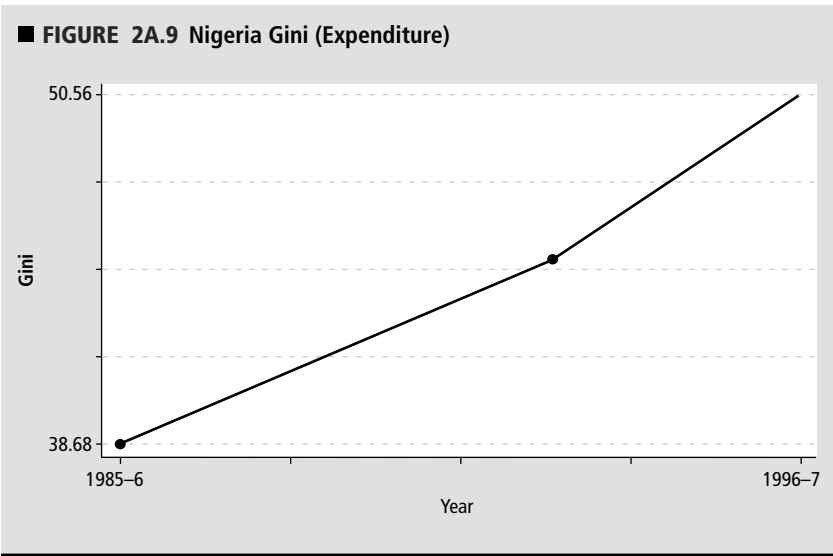


Source: World Bank Povcal database.

Note: Data-type information missing for the 1998 and 2000 Ginis is assumed to be expenditure.

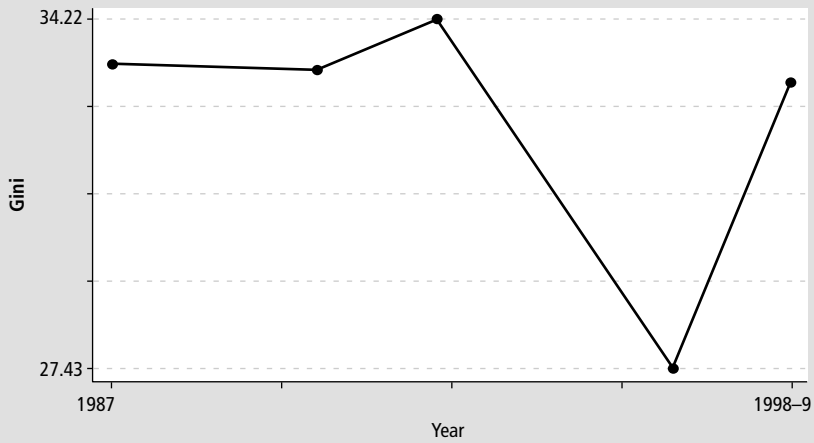


Source: World Bank Povcal database.



Source: World Bank Povcal database.

■ FIGURE 2A.10 Pakistan Gini (Expenditure)



Source: World Bank Povcal database.

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3

Assessing the Trade and Poverty Nexus in Latin America

Paolo Giordano and Victoria Florez

In the last two decades, Latin American countries undertook significant structural reforms with the objective of facilitating economic growth, development, and poverty reduction. Trade liberalization featured prominently in the reform process and was pursued through an integrated strategy that included unilateral liberalization and reciprocal negotiations at the multi-lateral, regional, and bilateral levels (IDB, 2002).

Trade-liberalization initiatives are not new to the region. Indeed, they materialized in two successive waves of reforms documented by Devlin and Estevadeordal (2001) and Devlin and Giordano (2004). But in neither episode was trade liberalization systematically complemented by policies to help countries maximize and better distribute the benefits of trade reforms. Reducing poverty via trade reform is emerging as a key priority for the region.

Latin America has one of the most unequal distributions of wealth and other assets in the world. The richest one-tenth of the population earns around half of the region's total income; the poorest earn less than 2 percent. This stark inequality is found not only in income distribution but also in access to education, health, credit, and other assets that are crucial determinants of national development, social cohesion, and individual well-being. This explains why Latin America, despite comprising mostly middle-income countries, suffers from high levels of poverty. Indeed, such inequality is one

The opinions expressed herein are those of the authors and do not necessarily reflect the official position of the Inter-American Development Bank or its member countries. Thanks to Roberto Bouzas, Julio Guzman, Christian Volpe, and Erick Zeballos for comments on an earlier version and for helping frame the scope of this survey. This study is also published in Spanish as "Una evaluación del vínculo entre comercio y pobreza en América Latina," in Roberto Bouzas (ed.), *Después de Doha: la agenda emergente del sistema de comercio internacional* (Madrid: Marcial Pons—Ediciones Jurídicas y Sociales, 2007).

of the main drivers of the region's persisting poverty, which still affects 221 million people, or 44 percent of the population (ECLAC, 2004).

Income inequality in the region has grown, on average, during the last three decades. The pace of this increase, however, slowed slightly during the 1990s. This trend was the result of inequality rates falling in the most unequal economies, such as Brazil, but rising in some of the less unequal economies, including Uruguay, Venezuela, and—most strikingly—Argentina. It is important to understand how trade liberalization has affected these changing patterns of growth, inequality, and poverty. This is especially true since Latin American countries are, on average, relatively closed to international trade; in the coming decades, under the pressure of globalization, they are expected to open up even further and adjust to compete in an increasingly dynamic global environment.

Meanwhile, putting trade integration at the service of development has also emerged as a priority at the multilateral level. The ongoing round of multilateral trade negotiations, including the Doha Development Agenda, tells of the importance of making trade work for the poor. The launching of the Aid for Trade initiative at the 2005 Hong Kong Ministerial Conference underscores the consensus of World Trade Organization (WTO) members about the need to formulate and monitor policies aimed at better distributing the benefits of trade liberalization. For Latin America, mobilizing aid for trade and harnessing trade liberalization for development is a centerpiece of development strategy (IDB, 2006).

Despite the growing political priority of making trade work for the majority (rather than only the rich minority) in the region, a notable gap exists in the knowledge of the distributive impacts of trade integration. As Bardhan (2006) puts it, "Many people have strong opinions about globalization and all of them are concerned with the well-being of the world's poor. The strength of their conviction is often in inverse proportion to their robust factual evidence." Giordano (2007) highlights some of the most striking knowledge gaps prevailing in Latin American policy circles.

This study attempts to fill this gap by reviewing the relevant literature on the distributional effects of trade liberalization in Latin America. It focuses more specifically on the impact of trade on growth, employment, wage inequality, and poverty. Macro methods focus on cross-country comparisons to evaluate the impact of trade on growth and its effect on income distribution and poverty at the national level. But emphasis will be put on the newest

micro-based approaches that rely on household-level data to evaluate the impacts of specific trade reforms on relative prices and wages, and to assess how this translates into changing inequality and poverty outcomes.

The study is organized as follows. Section 3.1 reviews some of the most renowned surveys on trade, inequality, and poverty. As stated by Goldberg and Pavcnik (2004), “the number of literature reviews alone is so large by now, that it seems that a review of the literature reviews would be appropriate.” Given this state of affairs, the following sections will cover only an illustrative sample of the literature, essentially the newest empirical contributions that focus on Latin America, restricting the scope of the investigation to the analysis of trade liberalization in an attempt to disentangle this discussion from the wider debate on globalization.

Section 3.2 discusses the methodological foundations of the analytical debate. It first reviews the concepts of globalization, trade integration, inequality, and poverty and discusses issues related to their measurement. Subsequently, it examines the causal links among them and illustrates the main mechanisms through which trade liberalization can affect poverty.

Section 3.3 reviews the empirical evidence on trade, growth, inequality, and poverty. It starts by briefly sketching the cross-country evidence and the wider debate on trade and growth. Most authors of the controversial empirical literature, based on aggregate data, find it difficult to identify a robust relationship between trade reforms and poverty reduction. Emphasis is placed on the empirical studies that contradict the standard predictions of neoclassical trade theory, particularly those that appraise the distributional impacts of factor endowments, explore trade-induced wage inequality, and unveil the existence of an intertwined, regressive, skill-biased technological change. In turn, the analysis of *ex ante* predictions focuses on the emerging micro-macro literature that links partial and general equilibrium models with household survey data analysis.

Finally, section 3.4 discusses some of the recent literature on trade integration and complementary policies.

3.1 An Overview of the Literature

In setting out the range of analytical tools available for evaluating the poverty impacts of economic policies, Bourguignon and Pereira Da Silva (2003) note

that “while there is a wide range of methodologies available for assessing the micro-economic impacts of micro policies and similarly many tools for assessing the impact of macro policies on macro-economic variables, there is a gap in understanding the micro implications of macro policies, including trade policy.” Accordingly, literature surveys have recently moved from macro and top-down to micro and bottom-up approaches.

Bhagwati and Srinivasan (2002) and Berg and Krueger (2003) assess the importance of trade policy for poverty reduction from a macro perspective. The latter focus mainly on the links between trade and growth to determine the changes in poverty by evaluating the variations in per capita income. They compile evidence from a variety of empirical sources to conclude that, generally, openness to trade is an important contributor to growth and that growth associated with trade liberalization is as propoor as growth in general.

Winters, McCulloch, and McKay (2004) and Ravallion (2004b) deepen the scope of the debate. Their reviews encompass mainly empirical studies of ex post data pertaining to actual episodes of trade liberalization, but refer occasionally to ex ante partial equilibrium and computable general equilibrium (CGE) methodologies. They conclude that, although there are many causes for optimism that trade liberalization will contribute to poverty reduction, once it is properly measured, the impact is not expected to be substantial. They stress that it is hard to make an explicit theoretical or empirical generalization that trade liberalization can facilitate poverty alleviation. The ultimate outcome depends on a wide set of country-specific factors, such as the importance of local institutions in determining the transmission of border prices to local levels, the rigidities of labor markets, the strategic responses of households at the micro level, and the existence of concurring factors that need to be controlled with a wide set of complementary policies.

Hertel and Reimer (2004) place particular emphasis on the last generation of empirical studies, which strive to elicit the disaggregated household and firm impacts of macro trade policy. They highlight the critical role of factors markets. Most of the evidence points to the dominance of earning-side impacts over consumption impacts, which is problematic since household surveys are notable for their underreporting of income. From the perspective of the poor, the market for unskilled labor is the most important. In fact, they argue that the poverty impacts of trade policy often hinge on how well the increased demand for labor in one part of the economy is transmitted to the rest of the economy via increased wages, employment, or both. Therefore, the

authors recommend further econometric research aimed at discriminating among competing factor mobility hypotheses.

Goldberg and Pavcnik (2004) shed more light on trade-related labor market adjustment. Their survey focuses on short- to medium-term changes in relative prices and wages, rather than on the dynamic, indirect relations linking trade, growth, income inequality, and poverty. They also narrow their appraisal of the empirical evidence to concentrate on recent major trade-liberalization episodes that occurred in developing countries. They find that—despite measurement problems, identification difficulties, and conflicting evidence on some issues—the empirical literature has established some consistent patterns across countries and episodes. Given the fact that the most heavily protected sectors in developing countries employ a heavy proportion of unskilled labor, it should not come as a surprise that trade liberalization has a negative impact on unskilled workers in the short and medium run. The empirical work surveyed consistently documents a lack of major labor reallocation across sectors (although more disaggregated analysis using plant-level and household data seems promising in this regard). Nevertheless, they confirm that given the magnitude of the trade reforms, the effects uncovered are small and can explain only a small fraction of the general increase in wage inequality.

Harrison (2005) summarizes the results of a research project that gathers cross-country and country-specific case studies on two facets of globalization: trade and financial integration. The conclusion succinctly summarizes the emerging consensus on the indirect relation between trade and poverty and its policy implications. Since the poverty outcome of trade integration depends on a broad set of interrelated factors, a wide set of complementary policies should flank trade-liberalization initiatives. Considering that trade liberalization generates winners and losers, it is crucial to provide opportunities to potential winners, particularly through the generation of expanded market access and policies aiming at sustaining their competitiveness. Likewise, it is crucial to provide transitional support to potential losers, particularly in the form of measures facilitating the exit from contracting sectors and the relocation to expanding ones, along with safety nets aimed at protecting the most vulnerable.

Turning to *ex ante* evaluations, two international research projects led by Cline (2004) and Hertel and Winters (2005) offer comprehensive assessments of the poverty impacts of the Doha Development Agenda negotiated under

the WTO. Both projects are illustrative of the most recent vintage of micro-macro methodologies that couple CGE evaluations accounting for commodity, terms of trade, and factor markets effects with poverty incidence analysis based on household surveys. Bouët (2006) aptly summarizes the results of 11 studies pertaining to this new generation of models. He shows that the welfare gains expected from a highly hypothetical full liberalization scenario (the complete removal of trade distortions across the board) vary from 0.2 percent to 3.1 percent and that the number of people who may be lifted out of poverty ranges from 72 million to 446 million. These figures have spurred some criticism regarding the effectiveness of CGE models in producing reliable *ex ante* predictions of the poverty impacts of trade reforms (see, for example, Ackerman, 2005). A careful analysis of the underlying factors explaining diverging results from these “black boxes” reveals the crucial importance of assumptions relating to the models’ simulated scenarios, underlying data, behavioral parameters, and theoretical specifications.

There are only a handful of essays that have attempted to summarize the literature on trade and poverty in the region. Their conclusions are generally aligned with those of global studies.

Bouzas and French-Davis (2003) review the literature on globalization and equity, placing emphasis on financial and macroeconomic issues. They conclude that there is little consensus in the literature as to what accounts for the increase in inequality and poverty in Latin America. More generally, they underline the importance of country-specific analysis as they show that the empirical work reviewed frequently reaches opposite conclusions, as in the case of Morley (2000, 2001), who finds a negative correlation between trade and equity, and Behrman and others (2003), who do not find any correlation between these two phenomena. There seems to be more consensus on the importance of domestic policies and institutions in transmitting the effects of globalization. Bouzas and French-Davis (2003) advocate the need of more research and suggest the adoption of a more balanced and careful approach than the one that has prevailed in academic and policy circles in the last two decades. A similar conclusion is reached by Ventura-Dias (2005) in the case of Brazil, with a focus on the narrower issue of trade liberalization.

The most up-to-date and comprehensive review of the literature available on the social impact of economic integration in Latin America is that of Berry (2006). Echoing Bouzas and Keifman (2003), he relates the poor social outcome of Latin American economic integration mainly to the modalities and

sequence of trade liberalization, financial integration, and structural reforms. He concludes that asymmetric integration could be corrected with actions on the trade side, particularly through gaining access to developed economies' markets and implementing a more heterodox mix of complementary policies, featuring export promotion and even selective protection.

The overview of literature reviews on trade and poverty at the global and regional levels reveals a gap in the knowledge base used by policymakers to address this emerging priority (Giordano, 2007). To elucidate the trade-poverty nexus we must sketch an analytical framework that links all the variables at play. This is the objective of the next section.

3.2 The Scope of the Trade-Poverty Nexus

Most economists accept that, in the long run, open economies tend to produce better outcomes than closed ones. But a consensus has not been reached on how exactly economic openness should be measured and on the exact meaning of "better outcomes" from the perspective of social equity and poverty levels. Even less clear is the causal direction of the relationship between trade and poverty.

Measuring Trade, Inequality, and Poverty

The concept of trade openness is the object of an unsettled debate. In fact, the impact that trade might have on poverty and inequality depends on how each variable is measured. As Harrison (2005) points out, measures of export activity are generally associated with poverty reductions, while removal of protection or variations in import shares are frequently associated with increasing poverty.

Trade integration. Openness to trade can be measured using direct policy measures such as tariffs and equivalents of other trade-protection instruments or indirect outcome-based measures such as trade openness—that is, the share of imports plus exports in the overall gross domestic product (GDP) (see also Hausmann and Klinger, 2006). Most of the recent studies favor the use of direct policy measures, considering that trade shares are determined by trade policies, geographical location, country size, and macroeconomic

policies (Harrison, 2005). But Berg and Krueger (2003) point out several problems that arise when measuring openness and looking directly at instruments that restrict trade, such as tariffs and nontariff barriers (NTBs). Simple and aggregate averaging does not capture the relative importance of different categories of goods. At the same time, NTBs are extremely hard to measure. Measures of trade protection in the services sector are often not available.

Goldberg and Pavcnik (2004) argue that the use of tariffs provides advantages as they can be comparable across time and vary substantially across industries during trade reforms. They maintain, however, that even though the measurement of openness through tariff changes represents improvements over previous measures, it depends on the specific country and its use of tariffs. Progressively, for example, in Mexico following the North American Free Trade Agreement (NAFTA), tariffs are becoming rather irrelevant, while other trade-restricting measures such as antidumping duties, NTBs, and regulations in general could play a more important role.

Ad valorem equivalent (AVE) tariffs have therefore been considered a more accurate measure of openness than nominal ad valorem tariffs as they provide reliable estimates of price or quantity distortions caused by trade policies. This issue is particularly relevant for CGE models that rely heavily on the correct measurement of trade protection. Indeed, the shrinking gains from trade liberalization documented by Bouët (2006) are—in large part—due to the incorrect measurement of trade protection, the lack of consideration of trade preferences, and the use of ad hoc aggregation procedures. A robust identification of AVEs—such as that used in Giordano, Méndez-Parra, and Watanuki (2007a, 2007b)—reveals a high sensitivity of CGE model results to the assumptions made on trade-protection measures. This is particularly important in the agriculture sector, which is protected by tariff-rate quotas, specific and compound tariffs, and domestic support measures for which AVEs are difficult to determine. Moreover, AVE measures are highly dependent on the reference prices used—an issue hotly debated and only recently settled in the WTO.

Kee, Nicita, and Olarreaga (2006) make a valuable contribution to overcoming problems aggregating both tariffs and NTBs. They build two average ad valorem measures of protection for each trade-restrictive policy instrument, which, when combined, total the level of protection that a given country imposes on imports. Accordingly, the Tariff Trade Restrictiveness Index is a weighted sum of protection levels built upon tariff rates and NTBs, import-level data, and the elasticity of demand for imports. By taking into account the sensitiv-

ity of imports to changes in protection levels, the approach goes beyond the conventional methodology used in the calculation of import-weighted tariff rates and reduces the possibility of underestimating trade-protection levels. But this index has not been used in poverty-related studies so far.

Inequality. The effects of trade liberalization on inequality also depend on how inequality is measured, which is not an easy task, considering that the concept is in itself controversial. Ravallion (2003) emphasizes the importance of distinguishing the concepts of relative and absolute inequality. Relative inequality depends on the ratios of individual incomes to the overall mean: if all incomes grow at the same time, relative inequality remains unchanged. Absolute inequality, on the other hand, depends on absolute differences in standards of living.

The perception that inequality rises with trade openness often points to inequality measured in absolute terms. But as illustrated by Goldberg and Pavcnik (2004), most of the recent work on developing economies has focused on the relative version of inequality and still found that trade reforms coincide with an increase in relative inequality, which implies an even larger increase in absolute inequality.

In addition to the debate on the correct measure of inequality at the individual, household, or national level, a recent debate has underlined the lack of consensus on how to measure inequality at the global level (see, for example, Lindert and Williamson, 2001; O'Rourke, 2001; Cornia, 2003; Wade, 2004; and Sala-i-Martin, 2006). Three different measures are commonly used: (i) inequality among countries, considering each country as a single observation; (ii) weighted inequality between countries, considering the size of the population as weights; and (iii) inequality among individuals without considering their country of origin. Conflicting measures have produced contrasting views on the impact of trade integration on inequality, as reported by Milanovic and Squire (2005).

Poverty. Finally, there is an unsettled debate on how to measure poverty, which generally focuses on three alternative measures: the headcount, the poverty gap, and the severity-of-poverty index. The headcount is defined as the prevalence or incidence of poverty and is measured by the fraction of the total population living below the poverty line (defined as a level of either minimum income or consumption). The poverty gap is the mean shortfall from the poverty line, expressed as a percentage of the poverty line and re-

flecting the depth of poverty as well as its incidence. The severity-of-poverty index is computed as the degree of inequality among the poor.

Measuring poverty and its association with macro phenomena such as growth or trade openness is also controversial because of the very nature of the underlying data. Poverty measures are usually extrapolated from household surveys. As stressed by Deaton (2003), national accounts and household data are often difficult to reconcile, and the latter are—in most cases—plagued by errors, omissions, and underreporting bias. Synthetic measures, such as the poverty elasticity of trade opening—often touted to support strong arguments about the distributive impact of trade liberalization—should therefore be considered with caution.

Deaton (2003) and Ravallion (2003, 2004a) point out that an operational definition of poverty raises not only important measurement issues but also philosophical questions. Defining and measuring poverty is a very controversial issue because, besides being a subjective notion, the perception of poverty varies among and within countries. According to Ravallion (2003), those who say that globalization is good for the poor tend to be absolutist while many of the critics of globalization appear to think of poverty in more relative terms. But a relative measure of poverty is, by nature, similar to a measure of inequality. Recent contributions to the literature are progressively adopting alternative conceptualizations of well-being, deprivation, and poverty, which increasingly capture the multidimensional characteristics of poverty. Examples can be found in the computation of the composite Human Development Indicator (United Nations, 2005) or in the emerging economics of happiness (Graham and Pettinato, 2001).

How to measure trade openness, inequality, and poverty is therefore a very controversial issue in itself. Each measure entails a number of assumptions that may have an impact on the results of the empirical analysis. In fact, each measure provides information on a specific aspect of the multifaceted and multidimensional poverty phenomenon. It is therefore useful to track precisely the links among trade integration and the complex dimensions of inequality and poverty.

Sketching a Conceptual Causal Framework

Standard international trade theory provides several explanations of how trade liberalization can stimulate growth. Once a country opens up its economy, it

has the possibility of accessing new markets, new technologies, and appropriate intermediate and capital goods, which in turn causes increases in production, scale economies, and competitiveness. The workhorse of the theory of long-run economic growth is the neoclassical model based on Solow. In this framework, the level of GDP per capita in the steady state depends on anything that affects the level of productivity, such as distortions that affect the allocation of resources, as well as the determinants of the level of steady-state capital stock, such as the savings rate. By allowing a more efficient allocation of resources, openness raises the steady-state level of income and the growth rate for any country out of equilibrium.

Endogenous growth theory emphasizes that trade liberalization can promote economic growth in the long run through dynamic effects (Wacziarg, 2001; Wacziarg and Welch, 2003). This theory highlights the importance of technology diffusion that brings together trade and learning by doing. Moreover, it stresses that openness allows specialization of industries with scale economies and therefore boosts growth in the long run (see for example Lucas, 1988; Grossman and Helpman, 1991; or Krugman and Venables, 1993).

Despite the effort found in the literature to demonstrate that openness leads to economic growth, empirical findings are ambiguous. From the static point of view, a second-best theory suggests that in the presence of other distortions in the economy, free trade may not be the best option for growth. Open economies may also have a tendency to stagnate in industries without learning by doing—for example, when comparative advantages reside in activities that incorporate low levels of value added. At the same time, economic models with increasing returns to scale and externalities may generate situations in which factors of production flow out of the poor areas to the rich ones, generating so-called growth traps (Easterly, 2001).

Nevertheless, it is widely agreed that the best way for a country to reduce poverty rates is to grow. Trade liberalization might have an impact on growth and thereby an indirect effect on poverty reduction. As Sala-i-Martin (2007) puts it, “growth of per capita GDP shifts the mean of the income distribution to the right. If the dispersion (or inequality) of the distribution does not change, the poverty rate automatically declines. Poverty can also decrease if, for a given mean income, the dispersion of the distribution—that is, inequality—declines.” In other words, even though trade-induced growth can worsen inequality, it has to be very strong, if it is to increase poverty.

Winters (2000) developed a conceptual framework decomposing the links between trade policy and poverty through changes in relative prices, wages, public finance, and other general equilibrium effects.

Prices, income, and consumption patterns. Trade-liberalization policies can affect households and markets through tariff changes on relative prices. An increase in the price of a given good would have a positive effect on households that produce it and a negative effect on the ones that consume it. Thus, the net effect will ultimately depend on whether household members are net consumers or producers. Several studies, which are discussed in greater detail later, show how changes in prices due to trade reforms can affect the poor. In the case of Mexico, Nicita (2004) shows how international prices affect domestic prices differently, depending on the household income level and geographic location. De Janvry and others (1995) use a household survey of the *ejidos* (common lands) in Mexico and find that a significant number of maize producers do not produce for the market and have consequently not been directly affected as producers by falling prices following the implementation of NAFTA. On the contrary, significant gains have accrued to consumers who benefited from the falling food prices. The extent to which the majority of the poor in Latin America are connected to local and international markets is just beginning to be explored (IDB, 2007).

Wages and employment. Another mechanism by which trade liberalization can directly affect the poor is through the effect it has on wages and employment. In theory, developed countries are relatively abundant in skilled labor, while developing countries are relatively abundant in unskilled labor. According to a simple version of the standard two-factor, two-country Heckscher-Ohlin model, developing countries will specialize in the production of unskilled-labor-intensive products, while developed countries will specialize in skilled-labor-intensive products. According to the Stolper-Samuelson theorem that links product prices to factor returns, the price decrease in the import sector will reduce the wages of skilled workers (used intensively in the import-competing sector) and benefit the unskilled workers (used intensively in the export sector). Because the model assumes that the factors of production can move across sectors within a country, the price changes affect only the economy-wide returns to factors of production. Thus, trade liberalization should be associated with reductions in poverty and inequality in the devel-

oping countries. But the increase in the skill premium and evidence of rising wage inequality in many developing countries in the aftermath of trade liberalization contradicts the prediction of the Stolper-Samuelson theorem.

Several explanations have been offered to reconcile empirical findings with theories in regard to Latin America (Perry and Olarreaga, 2006). On one hand, labor in developing countries is not as mobile as the model assumes. Trade specialization, according to comparative advantage, causes an increase in unskilled labor income only if unskilled workers are able to move out of contracting sectors into expanding ones. Labor-market rigidities may have prevented this outcome (Goldberg and Pavcnik, 2004).

Another reason is that prior to the liberalization episodes, Latin American countries such as Colombia and Mexico protected the sectors that employed mainly unskilled labor. Many studies point to this as a reason why Latin American experiences do not match the theories (see, for example, Revenga, 1997; Hanson and Harrison, 1999a; and Attanasio and others, 2004).

In the presence of extreme factor endowments, Davis (1996) shows that the distributive impact of trade liberalization depends on the correct comparison of factor endowments, which is not the global economy but a cone of diversification within which one produces. In the face of the emergence of countries such as China and India, which export a great amount of goods produced with an intensive use of unskilled labor, Latin America may no longer have a comparative advantage based on a relatively abundant unskilled labor force (see for example Wood, 1997; Leamer and others, 1999; and Gourdon and others, 2006).

Likewise, the initial unequal distribution of factor endowments and the endogenous emergence of institutions that advantage the elite class may explain the persistence of inequality and poverty in the region (Engerman and Sokoloff, 2002).

Government revenue and expenditure. Trade liberalization can also affect poverty through government revenue and expenses. Given that, in developing countries, a considerable amount of government revenues come from trade taxes, trade reforms may produce an important fall in net revenues, thereby restricting the fiscal policy space. But trade reforms can also have a positive effect on government revenues through the expanded taxation of increased production driven by exports. The question is therefore how the fiscal effects of trade reforms translate into inequality and poverty. As maintained by

Emini and others (2005), the adoption of an alternative tax may be detrimental for the most vulnerable groups, particularly the poor. The authors evaluate the effects of replacing tariffs with value-added or consumption taxes, and in both cases, the substitution effects cause an increase in poverty. This issue is particularly important in Latin America, where several countries are facing the challenge of adapting their fiscal policies to a more open trading environment, while trying to preserve or even increase the progressiveness of the fiscal regime (see Paunovic, 2005; and Barreix and others, 2004, 2006).

Uncertainty and other dynamic general equilibrium effects. The static analysis considered so far is abstracted from the possibility of dynamic general equilibrium effects. In a world with uncertainty, it is possible that trade liberalization affects the likelihood of falling into or indeed emerging from poverty. First, by increasing trade exposure and generating volatility, trade liberalization changes the risk of being exposed to exogenous shocks that may have an impact on poverty (Krebs and others, 2005). Moreover, by restricting the possibility of using trade policies to compensate for adverse exogenous shocks, trade liberalization may limit the capacity of governments to react to unexpected shocks. Second, as previously noted, trade liberalization may be coupled with or even induce skill-biased technical change, which, in turn, may have adverse distributional effects. Finally, short-run adjustment costs may be magnified in the presence of labor-market rigidities and can have negative impacts on poverty (Banerjee and Newman, 2004). All these issues seem to bear a relation to the distributional impact of trade liberalization in Latin America.

Winners and losers from regional integration. Linking trade integration to growth, inequality, and poverty is an elusive endeavor; understanding the distributive impact of preferential opening is even harder. Yet in Latin America, regional integration has shaped the ways that economies opened up to international trade. Venables (2003) provides a framework to explain how the real income effects of regional integration are distributed among member countries. He argues that countries with “extreme” comparative advantages do worse than those with comparative advantages intermediate between those of their partners and of the rest of the world. His analysis warns of the dangers of South-South integration, showing that it may draw manufacturing production into richer countries at the expense of the poor

members of the region. It also suggests that low-income countries with prevailing incidences of poverty may be better served by North-South integration with high-income countries. In Latin America, the asymmetric distribution of the benefits of regional integration is emerging as one of the most hotly debated issues. There is growing consensus on the need to compensate for asymmetries by complementing integration at the regional level with local development and productive integration policies at the national level (Gordano and others, 2005).

The debate surrounding the measurement of the key variables at play in the trade-poverty nexus and the variety of channels through which multi-lateral and regional trade liberalization is causally connected with poverty reduction suggest that assessing the distributive impact of trade integration is mainly an empirical question, which is explored in the next section.

3.3 Evidence on Trade, Inequality, and Poverty in Latin America

Organizing the empirical literature on the trade and poverty nexus is not an easy task: as contributions vary in several dimensions, there is neither an obvious nor an ideal taxonomy. With some degree of arbitrariness, the literature has been organized in four main categories according to the methodology used to explore each dimension of the trade and poverty nexus.

Trade and Growth

Some of the early contributions to the trade and growth cross-country literature find a positive correlation. Dollar (1992) classifies Latin America as only moderately open with respect to Asia and concludes that shifting to a level of openness and exchange-rate stability comparable to the latter would allow the region to increase per capita growth by 1.5 percent. Sachs and Warner (1995) include 13 Latin American countries in their panel and show that, in the period 1970–89, open economies performed better than closed ones. But in Latin America, which started the liberalization movement later, results are mixed and rather inconclusive: Argentina, Costa Rica, Ecuador, El Salvador, Guatemala, and Uruguay are found to have grown more after the liberalization episode, while the opposite holds in Brazil, Colombia, Mexico, Nicaragua, and Paraguay. Building on Leamer (1988), Edwards (1998) attempts

to refine the openness measure using nine alternative indicators and includes 10 Latin American countries in the panel. He finds that trade openness favors growth, that poor countries catch up (trade openness allows them to grow faster), and that physical and human capital accumulation has an important positive role, while political instability is detrimental.

These studies were subsequently criticized for their measurements of openness and difficulties in justifying the causality direction. It is not clear if trade opening causes economic growth or if the opposite holds: countries open up to international trade once they reach a relatively high level of economic growth. Rodríguez and Rodrik (2001) were at the forefront of the critique. They objected to the choice of the openness indicators, maintaining that these are weak measures of the incidence of trade barriers. They also challenged the econometric strategies used, arguing that they produced biased interpretations. Moreover, they pointed out that the trade liberalization episodes were significantly correlated with other macro- and microeconomic reforms, such as the deregulation of foreign direct investment (FDI) and labor markets—all very relevant features of Latin American structural reforms.

Dollar and Kraay (2002) try to correct such methodological issues. They find “no evidence whatsoever of a significant negative relationship between any measure of openness and average income of the poor.” They maintain that the scope of their database, covering 76 countries, and their empirical techniques correct the shortcomings of the studies by Spilimbergo and others (1999), Barro (2000), and Lundberg and Squire (2000), who found a positive correlation between trade openness and inequality. As will be stressed later, in line with Leamer and others (1999), they find, nevertheless, that cropland per capita is associated with higher inequality. In line with Lindert and Williamson (2001), Dollar (2004) therefore attempts to close the debate on trade and growth noting that “even though no one study can establish that openness to trade has unambiguously helped [the poor], the preponderance of evidence supports this conclusion. . . . As far as we can tell, there are no antiglobal victories to report for the postwar Third World.”

But as newer data become available, the terms of the debate may change again. This is particularly important in the case of Latin America, which, on average, opened up to trade in the 1990s—a period not covered by the empirical studies reported so far. Although it does not explicitly address the distributive question, the contribution of Estevadeordal and Taylor (2007) stresses the importance of correctly identifying the period of the analysis,

what they call the post-General Agreement on Tariffs and Trade “great liberalization” period. Noting that the empirical basis for judging recent trade reforms is remarkably weak, they use a model-based econometric technique, which highlights the role of tariffs on capital goods, compiles a new set of disaggregated tariff measures, and employs a treatment-and-control empirical analysis of pre- versus post-1990 performance of liberalizing and nonliberalizing countries. They find evidence that liberalizing tariffs on imported capital goods did lead to faster growth, and by a margin consistent with theory.

Despite its liveliness and uncertain final outcome, the trade and growth debate is of limited relevance to Latin America. It certainly supports the notion that trade protectionism is not a recipe for poverty reduction but offers little guidance on how to make trade integration work for the poor. Therefore, the use of case studies, which rely on highly disaggregated data and take into account country-specific factors, can provide clearer answers on the likely impacts of trade liberalization on growth, inequality, and poverty.

Trade and Wage Inequality

Shifting the focus from trade and growth to trade and wage inequality, Milanovic and Squire (2005) shed new light on the debate. They use data covering the preceding two decades and show that increasing trade integration leads to rising inequality in poor countries and falling inequality in rich countries. They stress the lack of labor mobility and the power of unions to explain why increasing openness to trade is associated with rising wage inequality between industries in poor countries. Easterly (2005) argues that these findings are coherent with his “productivity” view, whereby exogenous differences in productivity lead to capital flows from poor to rich countries and exacerbate inequality in poor countries. Considering that, in Latin America, wage inequality accounts for a large share of income inequality, there is an abundant literature that explores how labor markets adjust to trade liberalization using country case studies.

This debate is grounded on earlier contributions that focused on the experience of advanced economies, stating that unskilled workers in industrial economies would be affected by competition from low-wage countries, causing wages to fall relative to those of skilled workers (see for example Leamer, 1993, 1994; and Wood, 1994). But it appears that, following trade liberalization, wage inequality increased in developing countries, and

emerging evidence is suggesting that low-wage countries experience a similar rise in wage inequality, which happens to be inconsistent with the predictions of the neoclassical Heckscher-Ohlin-Samuelson framework (see Robbins, 1996; Londoño and Székely, 2000; and Wood, 1997).

In the case of developing countries, Rama (2003) shows that although wages grow faster in developing economies integrated with the rest of the world, openness to trade nevertheless has a negative short-term transitory effect. Moreover, the effects of integration are not symmetrical, and wage inequality in developing countries is explained by a skill-biased wage premium. But FDI seems to be a more powerful driver of skill-biased wage inequality than trade integration. Indeed, Behrman and others (2003) analyze a panel of 18 Latin American countries in the period 1977–98 and find that trade openness had no significant effect on wage differentials, which are explained by other factors such as domestic financial reforms, capital account liberalization, tax reforms, and technological progress.

Several theoretical studies have attempted to explore how trade integration may contribute to skill-biased technological change and wage inequality. Acemoglu (2003) shows that trade opening may induce an increase in skill-biased technological change, creating a powerful force toward higher skill premiums in both skill-abundant and skill-scarce countries. Thoenig and Verdier (2003) show that skill-biased innovation may be a defensive strategy to adapt to globalization. Feenstra and Hanson (2003) show that trade in intermediate goods has the same impact on labor demand as does skill-biased technological change. Following Acemoglu's framework, Berman and others (1998) and Berman and Machin (2000)—using a sample of developed and developing countries—find that there has been a pervasive skill-biased technological change around the world, including in middle-income countries. Latin American countries are not the exception, but rather the norm. Sánchez-Páramo and Schady (2003) describe the evolution of relative wages in Argentina, Brazil, Chile, Colombia, and Mexico and find strong and consistent evidence of skill-biased technological change (except in the case of Brazil). At the same time, in their study, trade appears to be an important transmission mechanism as the increases in the demand for skilled workers took place at a time when countries considerably increased the penetration of imports.

Since the mix of countries in aggregate studies may be a crucial factor leading to different results, it is worth surveying some recent case studies

dealing with these issues. They focus mainly on Mexico, Colombia, Argentina, and Brazil, with scattered contributions on a handful of other countries. They present a fairly heterogeneous body of contrasting evidence.

Mexico. Hanson and Harrison (1999b) examine the implications of the 1985 trade reform on relative wages and employment, showing that wages of more educated and experienced workers rose. They find that the trade reform did play a role but other factors such as FDI, export orientation, and technological change were also important (Feenstra and Hanson, 1997). This confirms the earlier findings of Hanson and Harrison (1995), who developed a model of trade and FDI to study the effect of the latter on the relative demand for skilled labor. Using state-level data for the period 1975 to 1988, they find a positive correlation between FDI and the relative demand for skilled labor that explains a large portion of the increase in the skilled labor share in total wages, consistent with the hypothesis that outsourcing by multinationals has been a significant factor in the increase of the relative demand for skilled labor. Cragg and Epelbaum (1996) and Revenga (1997) provide further evidence along these lines.

Robertson (2000) recaps the evidence on the Mexican case, arguing that trade liberalization and labor deregulation led to an erosion of rents in protected industries that were less skill-intensive, while foreign investments increased the demand for highly skilled labor. But Acosta and Montes Rojas (2008) argue that the effects of technological change dominate trade-induced effects. Finally, Hanson (2005) goes one step further as he controls for regional differences demarcating states with high and low exposure to globalization. His results are in line with previous studies, but he shows that income inequality is explained by the fact that relative labor income in states exposed to globalization grew 10 percent faster than that in low-exposed states, where poverty rose relative to high-exposure states by 7 percent.

Colombia. Attanasio and others (2004) carry out an empirical investigation using detailed micro-level data from 1984 to 1998, concluding that trade reforms affected wage inequality through their impact on skill-biased technical change, industry wage premiums, and informality. The increase in the skill premiums was primarily driven by skill-biased technological change (as in Kugler, 2002). But they argue that wage inequality may have been, in part, motivated by tariff reductions and increased foreign

competition, as the sectors with the largest reductions in tariffs were those with the sharpest contraction of sector-specific wage premiums in nonskilled-labor-intensive sectors, and in those sectors that had lower average wages before trade reforms. The overall effects of the trade reforms on wage inequality are, in any case, small (see also Bussolo and Lay, 2003). Goldberg and Pavcnik (2003) provide additional empirical evidence on the widely unknown relation between trade opening and informality, showing that labor-market institutions play a crucial role. In fact, they document that firms responded to the trade shock by increasing informal employment, but only in the period before the labor-market reforms, when they had to face rigidities and imperfections.

Argentina. Bebczuk and Gasparini (2001) provide an overview of inequality trends in the period of trade adjustment and document a dramatic increase in the relative wage of skilled workers that is indirectly attributed, among other things, to trade opening. Galiani and Sanguinetti (2003) endeavor to track the causality link between the two phenomena using aggregate industry level and household survey data. They find a positive correlation between college wage premiums and import penetration. As in other countries, however, the direct trade-related effect explains only a small part of wage inequality. Galiani and Porto (2006) attempt to pursue a stronger identification strategy, one that is similar to that in Attanasio and others (2004) but compares two episodes of trade reform. They evaluate the shift from high protection to liberalization in the 1970s, compared with the slowdown of reforms in the 1980s and multilateral and preferential opening in the Mercado Común del Sur (Southern Common Market, MERCOSUR) in the 1990s. They find that the large tariff cuts (70 percent) of the 1970s explain up to 25 percent of the observed surge in wage inequality, while the moderate tariff cuts (12 percent) of the 1990s explain only 10 percent of the wage premium. They conclude that tariff reforms contributed partially to the observed increase in wage inequality, but other concurrent factors linked to the globalization process played a significant role, a conclusion stressed by Acosta and Montes Rojas (2008).

Chile. In the case of Chile, Beyer and others (1999) and Pavcnik (2000) find evidence of skill-biased wage premiums, but while the former attribute it mainly to trade liberalization, the latter stresses the role of investments, foreign technical assistance, and patented technologies.

Brazil. The results for Brazil—home to a great proportion of the region's poor—depart from those obtained in regard to other countries and provide fruitful ground for evaluating the conditions under which trade reforms do not have an adverse effect on industry wage differentials. Evidence produced by Arbache and Corseuil (2004) and Arbache and others (2004) finds results in line with other Latin American case studies. But Pavcnik and others (2004) show that while industry wage premiums are, in fact, an important component of worker earnings, their structure is relatively stable over time, and they find no statistical association with changes in trade policy. They conclude that trade liberalization in Brazil did not significantly contribute to increased wage inequality between skilled and unskilled workers. Likewise, Goldberg and Pavcnik (2003) find no significant effects of trade opening on informality. Gonzaga and others (2006) go even further; using a wide set of instruments to test the trade transmission mechanism, they conclude that trade liberalization reduced wage disparities in Brazil.

Ferreira and others (2007) combine the methodology used by Pavcnik and others (2004) and Gonzaga and others (2006) to study net trade-induced changes in industry-specific wage and skill premiums. The analysis covers the period 1988–95 and considers all sectors of the economy (including agriculture and services). Their main finding is that trade liberalization in Brazil did in fact contribute to the observed reduction in wage inequality in the entire Brazilian economy, not just in manufacturing. Unlike for other countries in the region, preliberalization tariffs adjusted by import penetration were highest for skill-intensive goods and fell more than those protecting other goods. This led to a decline in the relative price of skill-intensive goods and, consistent with the Stolper-Samuelson theorem, this decline led to a reduction of skilled wages and to a movement of workers away from previously protected industries.

Trade and Poverty in Partial Equilibrium

The most widely used methodology to assess the direct impact of trade liberalization on poverty relies on partial equilibrium estimates coupled with cost-of-living simulations (see Porto, 2003). The methodology tracks two transmission channels: (i) trade reforms cause the relative prices of traded goods to change, and (ii) the price variations affect households as consumers and income earners. This approach has the merit of being based on an

intensive use of household data information and the deficit of abstracting from general equilibrium effects such as terms of trade effects, consumption effects (households pay different prices for traded and nontraded goods), and labor income effects (factor demand and wages adjust in response to the trade shock). Price shocks that originate the effects on the poverty headcount ratio may be observed, *ex post*, in time series or predicted with partial or general equilibrium model simulations.

Argentina. Porto (2003) examines the implications of national and foreign trade reforms on poverty in Argentina. The former include the removal of import tariffs while the latter refer to the elimination of agricultural subsidies, tariffs, and NTBs in developed countries. His results indicate that from a starting point of 25.7 percent in 1999, a combination of national and foreign trade reforms would cause a decline in poverty ranging from 1.6 to 4.6 percentage points, depending on assumptions relating to the deepness of trade liberalization. Effects induced by foreign reforms are found to be much larger than those from national reforms. In a later work, Porto (2004) applies the same methodology to assess the effects of preferential opening in MERCOSUR. He finds that regional integration had propoor distributive effects because tariff reduction was greater in relatively skill-intensive sectors. The average compensating variation for the poor is up to 6 percent of initial expenditure, whereas for the middle-income households the gain amounts to around 3 percent.

Mexico. Nicita (2004) applies the same technique to study, *ex post*, the effects of trade liberalization in Mexico between 1989 and 2000, taking into account regional differences. He finds that trade liberalization, which lowered the relative prices of nonanimal agricultural products, reduced the cost of consumption but put pressure on households' agricultural income, thereby widening the income gap between urban and rural areas. While all income groups have benefited, richer households have benefited more in both absolute and relative terms: real income increased by 6 percent in richer households and by 2 percent in poorer. Similarly, differences are found in the geographic distribution, with the states closest to the northern border gaining three times more as compared to the least-developed southern states. In this case, trade liberalization had the direct effect of reducing the headcount of those in poverty by about 3 percent.

Colombia. Relying on a standard partial equilibrium methodology, Goldberg and Pavcnik (2005) limit the analysis to urban poverty and do not find any correlation between trade and poverty. Poverty in urban areas is highly correlated with unemployment, employment in the informal sector, and non-compliance with minimum wages. In the period under scrutiny (1986–94), most of the reduction in urban poverty is accounted for by within-group changes in poverty, rather than movements of individuals out of groups with high poverty rates, such as the unemployed, informal workers, or minimum-wage earners. It is therefore not surprising that the authors fail to find any evidence of a link between trade and urban poverty. They note, however, that in Colombia agricultural trade liberalization is limited, with a potentially significant effect on poverty in the short and medium term—a finding confirmed by Giordano and others (2007b).

Brazil. Krivonos and Olarreaga (2005) assess the impact that a potential liberalization of sugar regimes in the Organisation for Economic Co-operation and Development (OECD) countries could have on household labor income and poverty in Brazil. They estimate the extent to which world prices are transmitted to 11 Brazilian states to capture the fact that some local markets may be relatively isolated from changes in world prices. They then estimate the impact that changes in domestic sugar prices have on regional wages and employment, depending on worker characteristics. They measure the impact of a 10 percent increase in world sugar prices on household income. Their results suggest that workers in the sugar sector and in sugar-producing regions experience wage increases and expanded employment opportunities. More interestingly, households at the top of the income distribution experience larger income gains due to higher wages, whereas households at the bottom of the distribution experience larger income gains due to movements out of unemployment.

National case studies based on partial equilibrium modeling associated with cost-of-living analysis are illustrative of the simplest methodology available to track the trade and poverty nexus in household surveys. The growing evidence in Latin America suggests a wide range of poverty effects generated by trade integration. These studies have the advantage of being easier to understand than more complex models and allow the consideration of detailed market structure and behavioral heterogeneity. But they fall short of accounting for the general equilibrium effects that reverberate across sectors and national markets.

Trade and Poverty in General Equilibrium

CGE simulations allow the consideration of complex relations among sectors and agents in the economy, producing disaggregated counterfactual simulations at the microeconomic level while providing a consistency check on macroeconomic accounts. CGE models are calibrated with social accounting matrixes, which are complete, consistent, and disaggregated data systems that quantify—at a given point in time—the interdependence of commodity and factor markets, representative agents, and regions. CGE models are typically based on neoclassical theories of firm and household behavior and operate on a time frame long enough to achieve market equilibrium. While most are in perfect competition and comparatively static in nature, imperfect competition and dynamic versions are increasingly used to address specific issues (see Reimer, 2002; and Permartini and Teh, 2005).

A shortcoming of many CGE model applications used in the analysis of income distribution is that the identification of household income and consumption effects is limited by the high aggregation of households. Thus, standard models capture only one part of the distributive effects and typically lack sufficient disaggregation to trace fully the impact of policy simulations on poverty. To address this shortcoming, the most readily available technique is the association of a CGE simulation with a subsequent tracking of distributional effects in household surveys (Decaluwé and others, 1999). Almost all CGE applications performed to date—both in multiregion global models that include Latin American countries and in single-country models focusing on specific Latin American countries—follow this so-called micro-macro approach.

The most comprehensive assessment of the distributive impact of trade integration with CGE models in Latin America is provided by Vos and others (2006). Building on a previous collection of studies coordinated by Vos and others (2003), which dealt with the broader impact of economic liberalization, this collection of 16 comparable country case studies assesses the poverty effects of a wide array of scenarios such as unilateral tariff reductions, export subsidies, exchange-rate devaluations, and export promotion. The studies also consider (i) a hypothetical “full” multilateral WTO liberalization scenario, whereby tariffs and domestic support subsidies are completely eliminated, and (ii) a preferential Free Trade Area of the Americas (FTAA) integration scenario where tariffs are eliminated on a preferential basis

among the countries of the Western Hemisphere. The results show that, in almost all cases, unilateral liberalization increases output and either wages or employment, depending on the assumptions made on the labor-market closure. Labor inequality rises in almost all cases, particularly between skilled and unskilled workers, but does not lead to inequality in per capita income because of offsetting positive effects on employment. As these results contrast with the historical evidence surveyed in previous sections, they suggest that other disturbances played a significant role in the postliberalization adjustment. In general, WTO and FTAA scenarios bring about results in line with unilateral reforms.

Unilateral trade reform scenarios determine small positive poverty-reduction effects in all countries but Ecuador. The WTO and FTAA scenarios are propoor in the majority of cases but cause a modest increase of poverty in Costa Rica (only WTO), Ecuador, Paraguay, and Venezuela, mainly due to the regressive outcome of agriculture liberalization that is not compensated for by expansion in other sectors. In these experiments, labor-market parameters are crucial for explaining the inequality and poverty effects of trade liberalization. In particular, average wage increase, changes in the remuneration structure, and quantity adjustment in the form of reduced unemployment—in this order—explain most of the propoor trade effects.

The production of CGE-based micro-macro poverty assessments is expanding in Latin America, as shown by IDB, ECLAC, and CEPII (2007). This is fortunate because the high aggregation of the models used in multi-country projects prevents a detailed analysis of the countries of the region, as they are generally limited to the larger countries such as Brazil, Mexico, and Argentina (see, for example, Hertel and Winters, 2005; and Polaski, 2006). Likewise, highly aggregate studies are often based on oversimplified simulation scenarios that prevent an accurate exploration of trade-policy shocks and their distributive impacts.

This is particularly important in simulations of agricultural trade liberalization, a key factor for poverty reduction in the region because the sector is plagued by residual pockets of protectionism at the multilateral level (Falconi and others, 2005; Schejtman and Berdegúé, 2006). In an attempt to provide a more accurate assessment of the likely poverty impacts of the Doha Development Agenda for a wide set of Latin American countries, Giordano and Nogués (2008) review the available literature and compile micro-macro CGE evaluations based on detailed “realistic” scenarios (based on proposals

of the European Union, the United States, the Group of Twenty, and others) coupled with country and sector case studies analyzing the poverty impacts of trade protectionism. The case studies attempt to assess the extent to which international prices are transmitted to regional households. They show that agriculture protectionism is highly detrimental to the poor in the region and that the Doha Development Agenda is an opportunity for poverty reduction in Latin America. This is confirmed by Lara and Soloaga (2007) and Gomez and Soloaga (2007), who, in the case of Bolivia and Nicaragua, respectively, find that an ambitious Doha scenario may contribute to poverty reduction, while a limited one may have a regressive outcome. Moreover, they show that domestic investments in complementary agriculture extension may have a greater impact than trade liberalization.

A precise measurement of trade liberalization is also crucial for assessing the poverty impact of preferential integration. In the case of Costa Rica in the Central American Free Trade Agreement, Sánchez (2007) uses a dynamic CGE model coupled with microsimulations and carefully models the impact of tariff-phaseout schedules and tariff-rate quotas. He shows that trade liberalization may boost growth by 2 percent annually, which in turn may generate a small decline in the poverty headcount. Giordano and others (2007b) evaluate a wide set of Andean trade and integration options and the impact of the Andean-U.S. bilateral agreements. The results indicate that the impact of the trade agreements with the United States, the European Union, and MERCOSUR is unambiguously expansionary, although the gains are modest. The impact of a bilateral agreement with the United States is propoor for signing countries (Peru and Colombia) as it reduces poverty and narrows inequality, while the opposite holds for Bolivia if it does not join the agreement, and even more so if it loses current preferential access to the U.S. market. Labor income gains via job creation are the primary drivers of inequality and poverty reduction, particularly in rural areas.

Finally, in the case of Brazil, Ferreira Filho and Horridge (2005) highlight the importance of moving away from the representative household hypothesis, considering higher within-country heterogeneity. The model distinguishes 10 different labor types and has 270 different household expenditure patterns. Income can originate from 41 different production activities located in 27 different regions in the country. The CGE model communicates with a microsimulation model that has 112,055 households and 263,938 individuals. Poverty and income-distribution indices are computed over the entire sample

of households and individuals before and after the policy shocks. The results show that trade-policy shocks do not generate dramatic changes in the structure of income distribution and poverty. The simulated effects on poverty and income distribution are, in fact, positive but rather small. The benefits are nevertheless concentrated in the poorest households.

This succinct review of the newest contributions to the micro-macro poverty literature does not aim at surveying all available studies, a task that largely exceeds the scope of this chapter. It rather intends to highlight the need of more research specifically focused on Latin America and the advisability of moving away from misleading simplifications of trade-policy shocks, particularly those that simulate unrestricted liberalization across the board or do not accurately take into account the existence of a complex web of trade preferences.

3.4 Trade Integration and Complementary Propoor Policies

Despite the difficulty of finding a clear connection between trade liberalization and poverty reduction in both theoretical and empirical studies, there is a consensus among academics that protectionism is not a suitable policy tool for eradicating inequality and poverty. It is also widely acknowledged that trade liberalization is a means to achieve growth and not an end in itself. Trade integration alone is in fact not sufficient to generate sustained growth, even less to promote development at the same time as promoting equity and reducing poverty. Indeed, the literature reviewed so far very often emphasizes the fact that the distributive outcome of trade integration is inextricably intertwined with a wide array of structural and policy determinants.

Empirical evidence on the interaction between trade integration and complementary policies is very recent and limited. In a panel of more than 100 countries, Bolaky and Freund (2004) find that trade opening promotes economic growth only in countries that are not excessively regulated. Indeed, trade openness is associated with lower standards of living in excessively regulated economies. They argue that in highly regulated countries, trade fails to generate growth because resources are prevented from flowing to the most productive sectors and firms, and trade is likely to occur in goods that do not display comparative advantages.

Chang and others (2005) extend the scope of the analysis and provide empirical evidence of why trade-induced growth performance depends on macroeconomic, structural, and institutional characteristics that help a country adjust to a more open trading environment. They interact trade openness with proxies of educational investment, financial depth, inflation stabilization, public infrastructure, governance, labor-market flexibility, and flexibility of entry and exit of firms from the market. They find that trade liberalization promotes growth, except in those countries in which complementary areas are distorted.

Against this background, multilateral institutions are increasingly putting emphasis on the need to flank trade liberalization with complementary domestic policies, encompassing macro- and microeconomic interventions, institutional reforms, and social policies. For example, the OECD Trade and Structural Adjustment Report (2005) recommends adoption of macroeconomic policies that promote stability and growth; labor-market policies that facilitate worker mobility across occupations, companies, industries, and regions; an efficient institutional and regulatory framework; and trade and investment policies that support structural adjustment and are implemented gradually enough to enable affected parties to adapt rapidly enough to avoid policy reversal. The Human Development Report (2005) produced by the United Nations underscores the nature of a conditional relationship between trade and human development. It identifies internal and external conditions necessary to capture the social benefits of free trade. The policy agenda outlined therein includes the development of an industrial and technological strategy, the adoption of gradual tariff liberalization programs, the inclusion of disadvantaged populations in formal markets through the provision of basic capabilities, the creation of safety nets, and the acceptance of social and environmental costs involved in international trade.

Referring more specifically to Latin America, in its contribution to the WTO Aid for Trade Task Force, the IDB (2006) set the contours of a propoor trade agenda. In this light, the most pressing challenges that the region faces are to (i) increase welfare through trade performance, (ii) equitably distribute the gains from trade, (iii) adapt to the complexity of modern trade agreements, (iv) promote ownership of trade reforms, (v) further expand trade-related institutional capacity, (vi) secure adequate funding for trade-related assistance, and (vii) implement complementary domestic policies to secure an efficient and socially equitable transition to freer trade.

3.5 Conclusion

Summarizing the findings of more than 100 essays on the trade and poverty nexus is a daunting task. This survey focused on the most recent contributions available in the mainstream trade economics literature, attempted to assess the relevance of the literature for Latin America, and concentrated on specific quantitative empirical work on the region. It addressed the issue of how changes in relative prices due to unilateral, multilateral, and preferential trade liberalization affect growth, wage and income inequality, and poverty. It did not address certain aspects such as the links between trade and gender, small and medium-sized enterprises, local development, or the political economy, which have an important relationship with the trade and poverty nexus. The underlying rationale of this research was to restrict the analysis to theoretical and quantitative empirical work, leaving the investigation of more complex qualitative issues for future undertakings.

Despite the move toward more open trade regimes, Latin American economies are still relatively closed to international trade. Under the pressure of globalization, it is likely that in the coming years, the region will need to open further and adjust to compete in an increasingly challenging global environment. With asset allocation in Latin America among the most unequal in the world, assessing the region's trade and poverty nexus is crucial for devising policies aimed at better distributing the gains from trade. Focusing on Latin America in this context will provide policymakers and stakeholders with evidence necessary to underpin a debate that for now seems nurtured more by anxiety than by rigorous knowledge.

In this light, it is useful to refer to a few conclusions with the aim of building up a solid base for policy debates and future research.

There is a gap in the availability of methodologies to explore the link between macro policy reforms such as trade liberalization and microeconomic determinants of welfare and poverty. It is therefore crucial to invest in the generation of data and research techniques, to adapt the research agenda to the specific context of Latin America, and to consider qualitative issues that are difficult to measure. Meanwhile, normative statements referring to the trade-poverty nexus should cautiously consider the limitations of current positive knowledge.

Trade openness, inequality, and poverty are multidimensional concepts. Measuring and attributing causal relations among these variables without

carefully qualifying the specific dimensions explored or the particular transmission mechanisms at play may be misleading. It is important to disentangle the specific dimension of the trade and poverty nexus from the wider debate on globalization and financial integration, the competing concepts of relative and absolute inequality, and the objective and subjective dimension of poverty and deprivation.

Despite the impossibility of rigorously and unambiguously asserting that trade openness is conducive to growth and poverty reduction, the preponderance of evidence supports this conclusion. But the majority of empirical macro studies also show that the impact of trade on growth and poverty is also generally small and that the causes of indigence are to be found elsewhere. It is, in fact, extremely difficult to find evidence that supports the notion that trade protection is good for the poor. The question, therefore, is how to make trade and growth more propoor and not how to devise improbable alternatives to trade integration aimed at improving the livelihood of the poor.

Specific evidence on Latin America reveals that deductive generalizations of neoclassical trade theory and global cross-country empirical studies may be of little help in understanding the trade and poverty nexus in the region. Several factors may explain why the integration of Latin America into the global economy may not necessarily increase the wages of unskilled workers and reduce poverty. The most compelling arguments are related to rigidities in the labor markets, the historical pattern of protection that created rents in unskilled-labor-intensive sectors, the emergence of low-wage countries such as China and India that shift the comparative advantage of Latin American economies, and institutional factors that protract the effects of an initial unequal distribution of factor endowments against the poor.

Trade liberalization may, in fact, be associated with rising inequality. But country case studies present contrasting indications. Although there is some evidence of rising inequality in the aftermath of trade opening—such as in the case of Mexico, Colombia, Argentina, and Chile—it seems that the specific effects of trade liberalization are small or indirect. Skill-biased technological change, often directly related with the increase of FDI or with capital account liberalization, seems to have a stronger explanatory power than trade liberalization. There is also little evidence that trade opening has generated more informality. On the other hand, the case of Brazil, where trade liberalization seems to have contributed to the reduction of wage inequality,

is illustrative of the conditions under which trade reforms may have progressive distributive effects.

The empirical analysis addressing the direct effect of trade integration on poverty reveals a similar landscape. Trade integration seems to be good for the poor, but the effects are small. Generalizations should be taken with a great deal of caution because this is a domain where data may present considerable shortcomings. In any event, it seems that foreign trade reforms are more important for poverty reduction than unilateral ones or than the national component of reciprocal trade reforms. The countries of the region may therefore expect further contributions of trade integration to poverty reduction, particularly from the liberalization of the agriculture sector, where the greatest pockets of residual protectionism are still concentrated. But predicting, *ex ante*, the propoor effects of trade reforms is an extremely sensitive task highly dependent on the quality of the data and the correct specification of the simulation instruments. It is hard to overstate the importance of strengthening the capacity of policymaking in this area.

Finally, considering that the trade and poverty nexus depends on a number of interconnected factors, a consensus is emerging on the need to flank trade-integration initiatives with a wide array of complementary policies. There is, in fact, increasing evidence that the outcome of trade opening may be regressive in the presence of distortions in complementary areas such as macroeconomic policies, infrastructure, regulations, financial depth, labor markets, governance, and human capital.

It is therefore of the utmost importance to integrate trade into the development agenda of Latin American countries and to align consensus, policy priorities, and financial resources with the objective of making trade work for the poor.

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4

The Effects of Economic Integration on Latin American Labor Markets: Some Policy Implications

Albert Berry

Latin American countries are renowned for their historically and stubbornly high levels of inequality. Because of this inequality, for any given level of per capita output and income that a country may achieve, the incidence of poverty is greater than it would be if the poorest were not so far below the average income. This is why Latin America, a middle-income developing region, suffers such high poverty levels. Hence it is here, of all developing areas in the world, that it is so important to achieve a propoor pattern of growth and find other ways to alleviate poverty. Growth that does not trickle down through the population is as much a failure as no growth at all.

In any society, poverty and inequality tend to be closely related to employment (here referring to both the quantity and the quality of available jobs) and to overall social policy,¹ especially in the areas of education, health, and pensions. The link to employment is crucial: for the majority of people and families in developing countries, labor earnings are the main component of income, and hence employment is the key determinant of economic welfare. This is especially true for lower-income groups. Employment opportunities depend on the demand for labor (defined broadly to include self-employment), on people's skills, and on how the labor market matches supply and demand. Measures of how people are faring in a labor market include such standard indicators as the (open) unemployment rate; the participation rate (PR) (the share of working-age adults in the labor force); and, in particular, data on income levels, inequality, and poverty. Poverty mainly reflects an inadequate demand for the labor of lower-skilled people. Inequality reflects some

¹ Thus Stallings and Weller (2001) refer to job creation as "the foundation for social policy."

combination of low demand for labor in general, contributing to a relatively low labor share of national income, a relatively greater demand for more skilled than for less skilled labor, and imperfections in the labor market that favor some workers over others.

As explained in more detail below, judging how satisfactory employment outcomes are in a country requires the use of income-distribution and poverty data, since such information summarizes the quality of labor-market outcomes. Trends in average income and its distribution thus usually reveal more about labor-market outcomes than do standard indicators such as the unemployment rate. Trends in the relative size of the informal sector, which offers less stable employment, simpler technology, and lower labor productivity, are similarly revealing. Because of the close links between an economy's performance in the areas of employment and of income distribution/poverty, employment policy and poverty/distribution policy are, to a large extent, the same thing.

4.1 Background

Judging on the basis of the crucial criterion of poverty, several facts in Latin America's record stand out. Solid growth averaging about 5.5 percent a year between 1950 and 1980 substantially reduced the incidence of poverty, from about 65 percent to 25 percent (Berry, 1997a).² Over the same period, inequality remained virtually unchanged for the region as a whole and played little role in the significant reduction of poverty. Neither the modest efforts that most countries made to confront inequality nor the growth process itself had much impact on inequality. Employment increased with the size of the labor force and unemployment rates rose and fell with economic cycles, but the key indicators of labor market outcomes were the level of income and the quality of employment (permanence, stability, working conditions, and so on). For nearly all major groups, average wages were rising and, for the most part, the quality of employment was improving.

After this period of broadly successful growth, progress came to a halt with the debt crisis of the 1980s: per capita incomes fell and poverty

² Figures based on a poverty line suggested by Altimir (1982).

climbed back to about 35 percent (by the standard just cited). By the early 1990s, the economic reforms introduced in the wake of the crisis were being implemented in the expectation that they would rectify the situation. Since then, however, growth has remained sluggish, averaging just 2.8 percent in the period 1990–2004—about 1 percent in per capita terms (somewhat less on a per worker basis, since the PR has been increasing)—and the level of inequality has risen in a number of countries without, it seems, improving significantly in any of them (ECLAC, 2000a). As a result, the incidence of poverty has, at best, fallen a little from its precrisis level.³ Regardless of the poverty line used, the incidence of poverty rose in the 1980s and fell in the early 1990s, but the decline stalled as the regional economy slowed in the latter part of that decade. By that time the reforms had cut public sector employment, increased openness and foreign competition, reduced agricultural subsidies, and curtailed the frequency of long-term employment, though in most countries such employment was in any case the privilege of a minority of workers (Gindling, 2005). In short, the income-related indicators reveal that Latin America had a disappointing 25 years after 1980, following a successful 35-year period.

Another cause for concern is the evidence that in some ways life has become more precarious over the past quarter century. Surveys by the Economic Commission for Latin America and the Caribbean (ECLAC) toward the end of the 1990s showed that “growing percentages of the population . . . felt that they were living in conditions of risk, insecurity and defenselessness” (ECLAC, 2000a: 16). The economic crisis of the 1980s and the ensuing combination of more open economies and lower worker protection in some countries raised the likelihood that middle-income households would be pushed into poverty (ECLAC, 2000a) and reduced the permanence and stability of employment.

³ Using two alternative World Bank poverty lines, \$1.08 and \$2.15 1993 purchasing power parity dollars per person per day, poverty incidence fell from 9.7 percent to 9.5 percent or from 26.9 percent to 24.5 percent between 1981 (when regional per capita GDP hit its precrisis peak) and 2001 (Chen and Ravallion, 2004). Using the higher poverty line employed by ECLAC, poverty incidence in 2002, at 44 percent, remained far above the 1980 level of 35 percent (ECLAC, 2003: 50). ECLAC’s “indigence line” lies between the two World Bank lines just cited, and shows a mild net increase in incidence from 18.5 percent in 1980 to 19.4 percent in 2002. It is the incidence of what might be called “borderline” poor that has increased most, from 16.4 percent in 1980 to 24.6 percent in 2002. Using ECLAC’s poverty incidence line, the jump from 35 percent in 1980 to 48.3 percent in 1990 was only partially offset by the modest fall to 44 percent in 2002. The absolute number of people in poverty rose from 136 million in 1980 to 221 million in 2002, higher than even the 1990 level of 200 million.

According to a Latinobarometer public opinion survey, 85 percent of Latin Americans in 1996–7 were either unemployed or worried about losing their jobs (IDB, 2004). The corresponding figure for Europeans was 32 percent. It has been suggested that the absence of widespread social insurance in Latin America may account for much of the difference, since the rates of job rotation are similar in the two regions. Even in the Latin American countries with quite low unemployment rates, this ratio is at least 65 percent, while the highest figure in Europe (Spain) is less than 50 percent and the lowest (Denmark) is less than 15 percent.⁴

As regards each of the major proximate determinants of poverty, Latin America's experience in the last 25 years may be summarized as follows:

- The growth rate has been slow, even in the postcrisis years since 1990, making poverty reduction difficult.
- Where it has changed, the inequality of primary income has usually worsened.
- Instability in incomes and jobs seems to have increased, and thus in some ways life has become more precarious.
- Poverty redress policies such as old-age pensions (in Brazil, for example) and subsidies to induce lower-income families to keep their children in school longer are becoming more frequent. The capacity of public health systems has also improved over time, partly as the population has moved from rural to urban settings. At the same time, targeting as a way of reaching the poor has hurt the near-poor who benefited from the previous universal programs.
- As regards the easily accessible indicators of welfare (and apart from those related to income and consumption), matters have changed for the better. Life expectancy has continued to rise. Though basic needs indicators are not consistently available for the region as a whole, educational attainment has improved, and housing conditions also seem to have done so. These developments are not inconsistent with the basic numbers on income and its distribution, since they partly reflect investments made in the past.

⁴ Another determinant of welfare and hence of poverty, it might be argued, is the quality of labor relations, which the Inter-American Development Bank (IDB, 2004: 12) describes as being "mired in conflict and distrust." This is, in part, a natural result of weak economic growth and a lack of good jobs opening up, but also owes something to the attempted reforms to make labor markets more flexible and to a history of conflict in certain countries.

On the first two points, the experience has been much poorer than might have been expected on the basis of the record of the previous 35 years and has fallen short of the hopes of the neoliberal policy reformers. As for efforts to redress poverty, the record gives modest grounds for hope that Latin America is moving haltingly toward better social safety nets of the sort available in industrialized countries.

Since inequality is such a central determinant of poverty and welfare, Latin America needs to achieve a propoor pattern of growth and pursue strong policies to redress poverty. Propoor growth mainly means growth that creates a strong demand for labor, especially for the usually less skilled workers from lower-income families. The need for an employment-creating pattern of growth is widely recognized as essential for poverty alleviation, but it is difficult to know which policies help produce that pattern.

Naturally, the misadventures of the past quarter century have prompted many questions. Some of these are geared toward explaining why circumstances have generally not been as good as before (or as good as expected) and why a few countries, especially Chile, have performed better than the rest. Other questions have focused on the effects of major policy changes—the market-friendly reforms undertaken in this period or the impacts of exogenous changes such as the information revolution.

Globalization and liberalization are major defining features of the last two decades. The former, at least in its economic dimensions, refers to the increasing degree of economic interaction among countries, reflected especially by the rising shares of world output that are traded internationally and by rapidly expanding international capital flows. This was the second wave of globalization (by most accounts the first occurred in the second half of the nineteenth century and the beginning of the twentieth), which stemmed from reductions in the cost of transactions across countries and from policy decisions that lowered barriers to trade and capital flows. Liberalization refers to reductions in government intervention, partly with respect to international interaction—the policy trend just mentioned—but also, more generally, in labor markets, domestic financial markets, and so on. It involves giving product and factor markets greater responsibility for resource allocation in an economy.⁵

In the three decades since the mid-1970s the countries of Latin America, at different times and at different rates, have become more integrated into the

⁵ For a more detailed discussion of the concept of globalization, see Scholte (2002).

world economy in general and, to a lesser degree, with each other. Integration has been very marked in the areas of international trade and capital flows. Table 4.1 summarizes data on trade ratios over the period. Foreign direct investment (FDI) has risen and technology transfer has accelerated, though this variable is not so easily measured as flows of goods, services, and capital. With respect to labor migration, by contrast, patterns have not changed significantly, although the economic flow of (mainly illegal) Mexicans to the United States has grown, and migration from El Salvador and Colombia has increased because of violence in those countries.

The main factor in the increased ratio of trade to gross domestic product (GDP) in Latin America has probably been the policy shift in that direction, reflecting the arrival of the neoliberal era and the “Washington Consensus” that inaugurated it. The shift was the result of several mutually reinforcing influences. A more market-friendly era in economic policy in general coincided with the international debt crisis that sprang from the oil-price hikes of the 1970s, the boom in private lending to developing countries and the associated accumulation of international debt, and the sudden reversal of capital flows that plunged the borrowers into crisis. Market-friendly reforms would not have been the policy response to balance of payments crises in earlier decades, but this changed.⁶ Debts had been allowed to rise higher than previously because of the ready availability of low-cost funds and could not be quickly paid off when real interest rates suddenly rose and the main industrial country markets were in recession. Developing countries, including most of those in Latin America, quickly found their balance of payments and international debt untenable; many were at the mercy of international creditors. The remedy prescribed by the International Monetary Fund (IMF) and the World Bank was a set of market-friendly reforms centered on freer trade and fewer controls on capital movements. Proponents of this policy shift emphasized the efficiency gains attendant on curtailing excessive government involvement and intervention in the economy and often argued that a more market-based approach would improve income distribution (see, for example, Little and others, 1970; Krueger, 1978, 1988; Balassa and others, 1971; Balassa and others, 1986).

⁶ When the basic disequilibrium in an economy is a balance of payments deficit, lowering barriers against imports is not an obvious remedy, and in earlier times the usual step was exactly the opposite—raising import barriers to cut spending on imports.

■ **TABLE 4.1 Exports and Imports, Latin America and the Caribbean and Selected Countries, 1975–2005**
Percentage of GDP, current prices

Country		1975	1980	1985	1990	1995	2000	2005
Latin America and the Caribbean	Exports	11.03	13.24	16.17	17.08	18.70	20.64	25.89
	Imports	13.37	14.81	11.76	14.81	19.15	21.58	23.19
Argentina	Exports	5.82	5.06	11.74	10.36	9.55	10.89	—
	Imports	5.98	6.48	6.27	4.63	10.08	11.52	—
Bolivia	Exports	25.94	24.53	19.05	22.78	22.55	18.27	—
	Imports	32.22	22.29	22.84	23.93	27.19	27.32	—
Brazil	Exports	7.54	9.05	12.25	8.20	7.72	10.66	22.66
	Imports	11.51	11.31	7.10	6.96	9.49	12.18	14.96
Chile	Exports	25.44	22.82	28.15	33.99	29.30	31.60	41.83
	Imports	27.41	26.98	25.71	30.55	27.10	29.73	33.56
Colombia	Exports	15.80	16.21	13.81	20.57	14.53	21.50	21.47
	Imports	14.07	15.58	12.53	14.82	20.96	19.40	21.36
Costa Rica	Exports	30.06	26.48	30.72	34.59	37.56	48.62	51.49
	Imports	38.55	36.82	32.48	41.36	40.37	45.77	54.33
Dominican Republic	Exports	27.72	19.17	28.15	33.83	30.94	44.87	34.72
	Imports	30.02	28.94	37.10	43.69	34.28	54.85	36.97
Ecuador	Exports	25.96	24.95	28.49	32.98	34.83	20.79	33.40
	Imports	32.16	27.10	23.24	32.00	51.22	34.19	35.95
El Salvador	Exports	33.05	34.16	22.32	18.56	21.64	27.40	27.15
	Imports	38.22	31.24	29.89	31.23	37.76	42.43	44.80
Guatemala	Exports	21.72	22.19	11.95	21.03	19.26	20.20	16.30
	Imports	23.53	24.92	12.98	24.84	25.43	28.95	29.38
Mexico	Exports	6.89	10.71	15.41	18.60	30.36	30.94	29.91
	Imports	9.62	12.97	10.33	19.71	27.70	32.93	31.52
Paraguay	Exports	13.21	15.31	22.10	33.25	34.83	20.79	33.40
	Imports	18.67	28.70	26.32	39.49	51.22	34.19	35.95
Peru	Exports	10.85	22.40	22.97	15.76	12.51	16.11	24.58
	Imports	21.94	19.42	16.46	13.83	18.20	18.03	19.36
Uruguay	Exports	16.78	15.03	26.76	23.53	19.00	19.30	—
	Imports	20.28	20.63	21.10	18.10	19.10	20.98	—
Venezuela	Exports	28.83	28.78	24.12	39.45	27.11	29.74	—
	Imports	21.93	21.83	18.07	20.18	21.82	18.11	—

Source: www.worldbank.org/dataonline.

Note: — = data not available.

In the quarter century since Latin America embarked on the policy shift toward economic liberalization—especially liberalization of trade and international capital flows, and to a lesser extent labor markets, along with

privatization of some activities that were previously the preserve of the state—the early optimism of its proponents has not been clearly borne out and criticism has increased. Discussion has focused on how to make the new policy arrangement more effective, rather than on reversing it, though the recent election of several left-leaning governments in the region will probably bring at least some modifications. In any case, debate will long continue about the merits of the neoliberal reforms. It is difficult to balance the costs and benefits of trade liberalization and the other market-friendly economic reforms—partly because many other factors have affected the outcomes of interest, partly because some benefits and costs may be delayed while others appear quickly, and partly because the balance between benefits and costs also depends on what governments do to enhance benefits, reduce costs, or make desirable policy changes when certain elements of previous policy are shown to be damaging. Exacerbating these problems, however, has been the dearth of adequate quantitative information and the lack of sufficiently in-depth analyses of the causal links among these developments. This chapter reviews the literature on the economic and social impacts of the cited trends in Latin American countries, particularly on labor market outcomes and the associated distribution of income. The key, interrelated questions of interest are:

- How has the increasing economic integration of Latin American countries affected their social and economic development?
- Which aspects of integration could and should be slowed or reversed, and which should be pursued further or accelerated?
- What complementary policies are desirable—either to help ensure potential benefits or to offset unavoidable negative impacts—if further integration is, on balance, either desirable or inevitable?

There is probably less agreement on the first point than on the others. On the second it is now quite widely agreed that unrestrained liberalization of international capital flows is dangerous, though what can and should be done about this is controversial. On the third, there is broad acknowledgment that integration can cause substantial losses for some groups and that remedial measures may be required. These questions are raised as awareness increases that income inequality is a chronic defect of Latin American society. Studies such as IDB (1999), ECLAC (2000a), and de Ferranti and others (2004) reflect that growing awareness and demonstrate how much

more is known about inequality and poverty. Unfortunately, they also tend to demonstrate the difficulty of moving from awareness of the features and correlates of poverty and inequality to identifiable and implementable policy measures that would likely have a significant impact on them. Policy suggestions tend to grow rather mechanically out of the correlations identified. Because inequality in the distribution of education underlies much of the inequality in labor incomes, education has been plausibly targeted as an area where effective policy might help diminish inequality. Because the informal sector, composed mainly of microenterprises, tends to be large in countries suffering high levels of inequality, microcredit schemes and other ways of improving the economic status of those firms have received much attention. Improvements in primary health care have sought to enhance poor people's access. All such approaches are logical and worthwhile. But it is hard to say whether any of them will have a significant positive impact on inequality, or even whether all of the current options taken together will make much difference. Optimism must be tempered for several reasons.

Most Latin American countries have suffered from a high level of inequality as far back as any usable evidence extends. This suggests that very deep-rooted institutional and other factors are responsible for creating and maintaining it. The durability of such built-in patterns has been emphasized recently (see, for example, Acemoglu and others, 2004) and confirmed by the few available studies that attempt to cover long periods.⁷ All of this suggests that breaking the pattern, or even bending it much, may be very difficult in Latin America.

There is extensive evidence, mostly from industrial countries, that relative income is an important determinant of welfare. Easterlin (1974), Scitovsky (1976), Hirsch (1976), and Frank (1997) have all argued that relative consumption is the central determinant of personal well-being in industrial countries.⁸ Changes in distribution are therefore likely to be the main source

⁷ For example, Berry (1990) concluded that the level of inequality in Peru was not much different between 1870 and 100 years later.

⁸ Specifically, when people in the industrial countries—where such surveys have been carried out quite often—are directly consulted about their happiness and its correlates, income seems to play a much smaller role than standard economic theory would suggest. It is moderately significant when the comparison is between people at different levels of the income hierarchy at a point in time but less so—some authors say virtually insignificant—as a factor in how average societal welfare changes over time, even when average incomes have risen considerably (Easterlin, 1974; Scitovsky, 1976; Oswald, 1997).

of changes in (meaningfully defined) poverty incidence. It might plausibly be guessed that absolute income would be a more significant determinant of self-reported happiness in lower-income (developing) countries, and the available data do show this. Frank (1997: 1834) notes that “most careful studies find a clear time-series relationship between subjective well-being and absolute income at low levels of absolute income.” Where most people lack minimally adequate shelter and nutrition, additional income yields significant and lasting improvements in subjective well-being (Diener and Diener, 1995). But as incomes rise, relative income or consumption becomes a more important determinant of welfare or happiness.

There is only a modest amount of empirical evidence on how inequality falls in countries anywhere. There is a growing literature on the historical record in the industrial countries, now going well beyond that available to Kuznets (1955) when he proposed regularity in which inequality tended first to increase with development, then to decrease. Subsequent research has clarified that declines in prefiscal inequality (that is, before the effects of taxes and government transfers) has been mainly the result of wars and depressions (Berry, 2008b). But since credible data started to appear for developing countries around the 1960s, there have not been many cases of falling inequality and the dynamics of the process have received only moderately detailed analysis of a sort that might make it possible to connect these country records to policy proposals like those currently mooted. In Latin America, unfortunately, there have been more cases of rising inequality than the opposite.

The premature introduction of inappropriate technologies into developing countries has long been correctly seen as a threat to job creation and income equality, which must be weighed against the fact that sometimes more capital-intensive technologies are more efficient even when labor is cheap compared to capital. It is widely believed that the information and communications revolution is one of the main technological breakthroughs of the past century. Although most empirical studies for the United States and other industrial countries show that the rate of productivity improvement was in fact lower during the last quarter of the twentieth century (approximately coinciding with the arrival of this “revolution”) than in the third quarter, recent studies (Jorgenson, 2005) indicate that the impact on total factor productivity (TFP) growth since some point in the 1990s has been high not only in the United States but in most other industrial countries. It seems likely that, when its

effects are completely diffused, this will indeed be one of the most important episodes of technological change. If this proves to be the case, and if this new wave of technology is substantially labor displacing, it may be a major threat to employment and equality in Latin America, at least in the short and medium run. Such new technologies, like heavily advertised industrial-country brands of products, can be a greater threat under conditions of economic openness than the opposite, though their potential benefits may also be greater. And undoubtedly there are benefits. Waverman and others (2005) estimate, for example, that for a developing country an increase in mobile phone density of 10 per 100 people would raise growth by about 0.6 percent. And some benefits clearly go to lower-income people, partly because the cell phone itself is now relatively widely diffused in many countries.⁹ So we must await a clearer picture of what the net employment and income distribution effects of this revolution will be.

Some of the policies of possible interest for job creation and poverty reduction are unlikely to be regarded favorably because they go against the grain of current market-friendly conventional wisdom. Large-scale expropriative agrarian reform is widely perceived to have been the central instrument in the few cases since World War II in which inequality did seem to fall significantly, though its effect in Latin America today could not be comparable to what it may have been in Taiwan a half century ago, since Latin America is now relatively much more urbanized than Taiwan was then. More relevant is the downgrading of “industrial policy” implicit in the market reforms. If that policy contributed significantly to Latin America’s success between 1945 and 1980 (and presumably even more to East Asia’s growth boom), then its loss could be an important barrier to growth and employment creation.¹⁰ Reversing recent liberalizing policy changes will be hard even if it is shown that they tend to increase inequality (a real possibility) and/or slow growth. Such reversal is more likely in the area of financial flows, where the costs of free market excesses are sometimes manifestly

⁹ In South Africa, a country with many structural similarities to Latin American countries, including a very high level of income inequality, half of the population does not have bank accounts, but 30 percent of these people do have mobile phones. Such phones are increasingly used for banking transactions. In Kenya a pilot scheme called M-Pesa is used to disburse microloans by phone (*The Economist*, October 28–November 3, 2006: 87).

¹⁰ For a persuasive discussion of how import substitution as part of an industrial strategy may contribute to rapid growth, see Bruton (1989).

apparent in the crises they produce; this would not be likely were comparable errors made on the trade policy front since the resulting losses would not appear in such dramatic form. In short, the battle against inequality and weak employment performance may often have to be fought without some instruments that, in a less constrained world, might be logical components of the policy package.

The attention paid by policymakers—in the countries themselves and in the international financial institutions (IFIs)—to creating employment and lessening inequality, as opposed to raising growth, has always been modest at best. That circumstance is reflected by, among other things, their weak understanding of the policy determinants of these outcomes. Hence, when a policy that might reduce inequality is also judged to be a threat to growth, it is unlikely to be pursued. In fact, most countries of Latin America and the developing world have nothing worthy of the name “employment policy” or “employment strategy.” To be effective, an employment strategy requires reasonably well-coordinated actions by a number of public agencies, including those that manage macroeconomic policy and those in charge of labor-market policy, trade policy, and other areas. It is likely to demand much effort and often pressure from above to achieve the needed levels of cooperation and coherence among those responsible for the various areas. Policymakers throughout Latin America now recognize the central role of small and medium-sized enterprises (SMEs) in creating adequate amounts of “decent” (that is, reasonably well-paying) employment. But policy in this area, like that for employment creation more generally, has not kept pace with the rhetoric. This is partly because the analysis of which policies work is not very developed and partly because, as with employment policy in general, good implementation requires good cooperation among public agencies.

For various reasons, some policies that seem promising cannot be implemented even if they are formally “adopted.” For example, policies to curtail the abuse of market power by large firms, or simply to discourage the growth of such firms when their impact is strongly labor-displacing, might be among the most promising of all employment policies. They might, for instance, be more effective than the various positive support policies for microenterprises and SMEs that, at least to some extent, are necessitated by the overpowering influence of large firms. But policy space is limited by the strength of the “free market” ideology, even when markets are highly

imperfect,¹¹ and especially when they are biased in favor of the large firms, and the related lack of political capacity or inclination to rein in large firms' behavior. Ironically, economic openness does curtail the monopoly power of some large producers but, in the process of raising the relative efficiency of those capital-intensive producers who can reap economies of scale and/or scope from world market coverage, it may penalize all competitors using labor-intensive technologies. More generally, trade liberalization per se contributes to inequality by leading to a higher concentration of activity in large firms,¹² a trend that both encourages capital intensity and may also, on balance, increase the degree of market imperfection. It usually has the former effect in manufacturing and agriculture, two sectors with generally large employment potential. The extractive sector tends to be capital intensive in any case.

Some of the apparently more promising policy areas cannot be expected to produce benefits in the short run. Thus it is recognized that the benefits of improving education, whatever they might be, will become apparent only a couple of decades after reform implementation (see, for example, de Ferranti and others, 2004).

Measurement and effective analysis of income distribution, and the labor market outcomes that mainly determine that distribution, remain defective in many countries; this poses a barrier to effective policymaking. Monitoring and ex post evaluation of policy instruments, using data on outcomes, is difficult. Most analyses, for example, do not or cannot establish the links between the distribution of earned income and that of household income.

Because of the above (and no doubt other) limitations on effective employment and income distribution policy, it is possible—even probable—that in the coming decades there will be little or no progress in combating inequality, even though average incomes rise and the average quality of employment improves somewhat. Even if some policy instruments are effectively marshaled

¹¹ A dramatic example of bad economic thinking on this issue is offered by a recent article in the *Harvard Business Review* (Prahalad and Hammond, 2002). It claims that multinational corporations can tackle poverty by selling to poor people. There is no recognition of the labor-displacing impact of the companies' presence in cases where they compete with more labor-intensive local technologies. Without such minimum insight into the complexity of the issue, such views do not contribute to the discussion or warrant serious consideration, but they do mislead some people.

¹² Among the factors contributing to this outcome are the significant economies of scale in undertaking long-distance and between-country commerce and the tendency for large commercial companies to buy from large producing units to minimize transaction costs.

in that battle, their benefits may easily be offset by other policies and trends working in the opposite direction.

Still, there are a number of reasons for optimism as regards employment and equality. Some of these stem from Latin America's current position in its economic life cycle, some from increasing policy expertise, and some from other factors. For one thing, it has become more difficult to avoid employment, equality, and poverty as issues that must be dealt with and against which governments (now democratic) will be judged. The first World Employment Program study by the International Labour Organization (ILO), undertaken in Colombia 39 years ago (ILO, 1970), signaled the start of somewhat serious political concern with this matter. Attention then waned during the 1980s debt crisis and only reemerged in the 1990s. The recent innovation of the Poverty Reduction Strategy Paper (Pottebaum, 2002) is likely to help improve policy in some countries eventually. Intriguingly, surveys report that some 80–90 percent of people consider prevailing levels of income inequality to be unfair or very unfair (de Ferranti and others, 2004: 4). This may be a good omen from a political viewpoint, since it may suggest some degree of public support for policy measures to reduce inequality.¹³

As the region becomes more urbanized, the rural-urban income gap emphasized by Kuznets (1955) as a significant component of inequality should continue to shrink. Urbanization, together with higher levels of education, may also have political benefits in the form of a more literate and politically involved populace that may help to hold governments accountable. And rising education levels may make the SME sector more viable in some circumstances by contributing to a better entrepreneurial base. The rate of population growth has been falling relatively quickly, thereby easing the strain on the labor market to create jobs. This decline also helps reduce inequality as the family-size gap between lower and higher income families is reduced. The growth rate of the working-age population in the region has been falling since around 1970, when it was about 2.8 percent. That of the labor force peaked at nearly 4 percent toward the end of the 1970s, and by 2000 it was down to about 2.4 percent (Weller, 2000). Child dependency is falling, but

¹³ Nonetheless, a more detailed look at the meaning of these survey results is needed. Less formal observation often reveals that people's sense of the unfairness of inequality relates to the gap between them and those above them, rather than that between them and those below them. If this explains much of the cited response, public opinion may not offer much support for broad redistributive policies, though undoubtedly certain types of redistribution (for example, helping the very poorest) do tend to have widespread backing.

old-age dependency is rising and will become much more marked within a couple of decades, putting pressure on the social safety net.

Researchers and practitioners have learned a good deal in some important policy areas. This understanding can be brought to bear and should pay off in better social outcomes. Thus the importance of and capacity to administer programs targeted at poorer groups have risen exponentially and microcredit is a tool in every country's economic arsenal. Modest expenditures on primary health care are known to be highly productive. Some previous policies are increasingly seen as counterproductive.

Some governments have increased capacity to carry out certain types of economic policy. Taxation has been one important area of progress. The countries of the region have long been noted for their low tax burdens relative to levels of development. Most need to raise tax incidence to undertake effective social policies. Though the administrative and political obstacles to doing so are daunting, Peru's experience in the early 1990s is encouraging, even though many of the benefits were subsequently lost because of the reemergence of old-style politics (Sheehan, 2003).

No one can predict with any certainty how the employment and equity performances of Latin America's countries will develop. Studies of employment and income distribution/poverty have focused unduly on micro-based analysis and broad cross-country analysis and too little on case studies, especially of countries that have experienced marked successes, either historically or more recently. The more typical approaches have been to find the correlates of inequality and poverty (for example, education and its distribution¹⁴) and to search for ways of attacking the problem through those correlates or to use the predictions of relatively simple theory (in trade and the labor markets, for instance) in the hope that reality corresponds. Both approaches are risky and neither appears to have borne much fruit thus far. Elements of standard static trade theory underlay the optimistic expectations of opening up, but events have clearly fallen short of these expectations. The literature says a great deal about the vicious circles of poverty, but it presents little evidence on how to disrupt or break out of them. Admittedly this is a hard challenge, since there are few well-documented cases in Latin America or elsewhere,

¹⁴ Unfortunately, much of the literature on the economic rates of return to education suffers from serious methodological flaws that render the conclusions much less solid than they are often believed to be (Pritchett, 1996; Rosenzweig, 1999).

and analysis of those few has not been brought much to bear on policymaking. Another significant limitation is our inadequate understanding of the social costs of economic insecurity and how these should be weighed against monetary gains, for example. Studies in countries such as Canada have shed some light on this issue (Osberg, 1998), but in Latin America it has received little attention although the available data, noted above, make clear how heavily insecurity weighs on the population. More generally, understanding of economic change in the context of a society's broad socioeconomic goals still lags far behind where it should be if it is to provide reasonable policy guidance on economic and social issues.

4.2 The Recent Evolution of Labor Markets, Inequality, and Policy

As noted above, economic performance in Latin America as a whole has been disappointing since around 1990, when the corner seemed to have been turned and the inflow of foreign capital resumed after the 1980s crisis. An important question is whether the unsatisfactory labor market outcomes are due mainly, or perhaps even wholly, to slow growth, or whether they are also due to the pattern of growth that has occurred.

With per capita income rising at an average of only about 1 percent per year between 1990 and 2004 and output per worker by even less, any general trend toward wage increases or a significant decline in poverty is not to be expected. Given the general expectation—based on empirical evidence—of an upward drift in productivity within the formal sector of an economy, even when growth is slow, an increase in the share of employment in Latin America's informal sector over this period is also unsurprising. Depending on how the fruits of rising productivity in the formal sector have been shared among capital, skilled labor, and unskilled labor, greater inequality of labor incomes might or might not be apparent and some increase in the inequality of total incomes (including income from capital and other nonlabor sources) might be expected. The available data on income distribution relate mainly to labor incomes and show some tendency toward increasing concentration over the period since 1990 and during the 1980s. Capital shares may also have revealed some upward trend (de Ferranti and others, 2004; Cornia, 2004; Yeldan, 2004), though this chapter has not examined the limited list of studies in detail.

In short, although as discussed below some interesting labor market patterns do emerge (a narrowing gender gap in earnings, for example, and the failure of the informal sector to shrink even during Chile's fast growth) that cannot easily be interpreted as normal results of a low growth rate, the general picture for the region as a whole involves no great surprises or dramatic anomalies. This is somewhat reassuring, because it lends credibility to the view that if growth can be accelerated, labor market outcomes will, if not "take care of themselves," at least be reasonably satisfactory. The main factors casting some doubt on this optimistic view are the high and rising levels of inequality and the expectation that some features of the growth patterns that have had ameliorating impacts in the past will have a less positive or more negative influence in the future. Fears related to several of the mechanisms known or believed to affect employment and inequality, and to some of the changes that have resulted from the liberalizing reforms, are plausible.

Before taking a more detailed look at how increasing economic integration into international markets has affected labor-market outcomes in Latin America, some of the salient patterns and trends in those outcomes are reviewed, focusing especially on the period since 1990.

Various types of information, used properly together, can shed light on the employment and other labor-market effects of economic integration. Conversely, many specific bits of information, used alone, can be misleading. It is reasonable to conclude that conditions are better the higher the PR (up to a point at least), the lower the open unemployment rate, the higher the wages and the labor share of national income, and the better the working conditions. But high wages at the expense of profits can be bad if this slows growth and future wage increases. High wages and good working conditions in any one part of the economy are a plus as long as they do not come at the expense of such desirable outcomes elsewhere. High wages may not be desirable if they come at the expense of employment, nor is high employment necessarily desirable if it comes at the expense of average wages. Thus, just as high productivity in some part of the economy (for example, modern manufacturing) is not a reliable indicator of overall performance, and may even be a sign of weakness, so it is with wages and working conditions in any one segment of the system.

Because of the numerous possible trade-offs among indicators, the single best gauge of overall labor-market outcomes is likely to be the distribution of income or of labor income. Other indicators are also useful when interpreted

judiciously and are necessary to understand why the overall outcomes turn out the way they do. The ideal package of information makes it possible to track, over time, the labor share (that is, the functional distribution of income); average wages and wages of each major occupational group, or earnings in the case of the self-employed; total employment and its composition by category and working conditions (including job security, job satisfaction, and so on); the rates of open unemployment and underemployment; average personal (earner) and household income and its distribution; and the relationships between each of these indicators and final or summary performance indicators. Since few (or perhaps no) empirical analyses provide all these indicators, it is necessary to bear in mind the possible failings of those that are available.

A first step in understanding how increasing economic integration has affected employment, wages, and other labor-market outcomes in Latin America is to develop a reasonably clear picture of what has happened in those labor markets over recent decades and the extent to which the outcomes reflect growth, technological change, and other factors that could be viewed at least partially as exogenous to the economic integration process. Then, with luck, some of the changes observed can be linked to the process of economic opening, or to labor-market institutions, which are also a topic of much discussion and debate.

What Has Happened to Labor Market Outcomes?

PRs, unemployment, and employment. Trends on the supply side of Latin America's labor market are by nature much smoother than those on the demand side but are nonetheless relevant when addressing the medium- and longer-run trends in outcomes. Population growth peaked around midcentury; it was at 2.7 percent per year over 1950–5 (ECLAC, 2004a) and has slowed gradually from 1.94 percent over 1985–90 to 1.47 percent over 2000–5 (ILO, 2003). Growth of the working-age population (those aged 15–64, by most definitions) peaked in the early 1970s at about 2.8 percent, while that of the labor force (employed plus unemployed) peaked at about 3.8 percent in the late 1970s (Weller, 2000) before dropping to a little under 2.5 percent by 2000.

Detailed and reasonably up-to-date data on most labor market variables are available only for urban areas, but since 75 percent of Latin America's population was urban by 2000 (ECLAC, 2004a) they give a good idea of what is happening on most counts. A key feature of the evolution of Latin

America's urban labor force during the 1990s was the continuing rise in female participation, especially in the mid-career age categories (25–49), where the typical increase was 10–15 percent over this short span. By 2002, therefore, female PRs ranged from a low of 31 percent (Chile, 15–24 years of age) to a high of around 75 percent in several countries (see table 4A.1).¹⁵ There has been a tendency toward convergence of PRs among the countries of the region, particularly for women. In most countries, female participation is strongly and positively related to the level of education (ILO, 2003), and hence part of the increase in average female PRs is associated with increases in average educational levels. But PRs appear to be rising even when both age and educational level are held constant.

For the region, the rate of open unemployment averaged about 6 percent over the first part of the decade, rose to 8.7 percent in 1999, and remained in that range to 2002 (table 4.2).¹⁶ While unemployment rose and fell with the economic cycles of individual countries, there was a net increase in most countries between 1990 and the late 1990s–early 2000s. Of the larger countries, the most marked increases have been in Argentina and Colombia (where the absolute rates for young people of both sexes reached extremely high levels);¹⁷ Brazil has also suffered a significant rise.¹⁸ Regional unemployment has fallen with the recovery of growth since 2003, by 1 percent over 2002–5, and was expected to fall by another point in 2006 to about 8.5 percent. This is still above the level of the early 1990s.¹⁹ One very favorable aspect of the recent improvement is the steep decline in the unemployment of the poorest

¹⁵ In most countries there has been a significant increase in the PRs of people aged 50 and over, though not always for males.

¹⁶ The redefinition of unemployment in the Brazilian series has led to an upward adjustment of that variable by 4.5–5.0 percentage points (ILO, 2003), which pushes the regional average up by about two points. For continuity, the old series is used here.

¹⁷ Rising nonwage costs could account for part of the increase in unemployment in Colombia, according to the analysis of Kugler and Kugler (2009).

¹⁸ There are some unresolved puzzles as to why urban unemployment rates vary so widely among countries of the region. In some cases (Dominican Republic and Jamaica, for example) the very high reported rates are due to unusually broad definitions of unemployment. Why Mexico's rate is systematically lower than that in countries like Chile and Colombia, under apparently comparable macroeconomic conditions, is not clear. These problems make regional averages harder to interpret, although since definitions do stay constant in individual countries over time, regional changes should be fairly accurately reflected in the data.

¹⁹ ECLAC (2006) indicates that despite the improvement due to the economic recovery of the previous four years, urban unemployment remained about 3 percent above its 1990 level. Assuming a drop of two points over 2002–6, the data in table 4.2 would suggest an increase of only about 1 percent between 1991

■ TABLE 4.2 Urban Unemployment Rates, 1980–90 and 1990–2003: Latin America and Selected Latin American Countries

Year	Argentina	Brazil	Chile	Colombia	Costa Rica	Ecuador	Mexico	Peru	Venezuela	Latin America
1980–90 ^a	6.6	5.3	11.9	11.2	5.4	—	4.3	7.4	9.3	6.6
1990	7.3	4.3	7.4	11.0	5.4	6.1	2.7	8.5	11.0	—
1991	5.8	4.8	7.1	9.8	6.0	8.1	2.7	5.8	10.1	5.7
1992	6.7	4.9	6.2	9.2	4.3	8.9	2.8	9.4	8.1	6.1
1993	10.1	5.5	6.4	7.8	4.0	8.3	3.4	9.9	6.8	6.2
1994	12.1	5.1	7.8	7.6	4.3	7.1	3.7	8.8	8.9	6.3
1995	18.8	4.6	6.6	8.7	5.7	6.9	6.3	7.9	10.3	7.2
1996	18.4	5.5	5.4	12.0	6.5	10.4	5.5	7.9	11.8	7.7
1997	15.7	5.7	5.3	12.1	5.9	9.3	3.7	8.4	11.4	7.3
1998	12.9	7.6	6.4	15.0	5.4	8.5	3.3	8.2	11.3	7.9
1999	15.1	7.7	9.7	20.1	6.0	—	2.5	8.3	14.9	8.7
2000	15.4	7.1	9.2	20.5	5.3	—	2.2	7.0	13.9	8.4 ^b
2001	17.4	11.3 ^c	9.1	16.9	6.1	8.5	2.4	9.2	15.1	—
2002	20.5	11.7 ^c	9.0	16.2	6.8	—	2.7	9.4	15.9	8.6 ^d
2003 ^e	16.4	12.4 ^c	8.9	16.3	6.7	—	3.2	9.4	18.9	—

Sources: Data for 1980–90 and for Latin America averages are from Stallings and Weller (2001). Other data are from ILO (2003). Both sources present annual data over 1991–2000. For some countries the figures match but for others they do not, although differences tend to be small and trends similar. The ILO source is chosen here because it includes more recent years and presents the results of the recent change of definition for Brazil. The Latin America average would be quite similar if calculated on the basis of the ILO figures.

Note: — = data not available.

^a Average for the decade.

^b Provisional.

^c New series, which is about 4.5–5 percentage points above the old one (ILO, 2003).

^d Approximation based on the figure presented in ILO (2003). Unrevised figures for Brazil are used for comparability with the earlier series. With the revised figures, the rate would be about 10.6 percent.

^e Until third quarter.

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deciles (ECLAC, 2006), although, as usual, it was still well above that of the richer deciles.

Between 1990 and the early 2000s the rising PR was approximately offset by the rising rate of open unemployment, so the ratio of employment to population over the age of 15 did not change significantly. The female PR continued to rise over the period 2002–5 in most countries (ECLAC, 2006), slowing the fall in the unemployment rate.

Given the continuing marked increase in female PRs since 1990, it might be suspected that this would lead to flooding of the occupational categories dominated by women, and hence to either a relatively higher level of female unemployment or a widening gender gap in incomes. Between 1990 and the third quarter of 2003, however, the data show no general trend toward a widening differential among the major countries in unemployment rates for women (table 4A.2) or to a widening gender gap in wages (see table 4.12).

Job quality. As in most developing countries, the main problem in Latin America's labor markets has not been the failure to create jobs but rather their quality, broadly defined (Saavedra, 2003). The sometimes mooted view that whatever growth there was in the 1990s was "jobless" is thus inaccurate, or at least badly phrased, even if employment growth did slow during the recession of 1997–8 in most countries. Employment growth was at its maximum in the 1970s (Weller, 2000) at close to 4 percent, and then fell in the succeeding two decades. The elasticity of employment growth to output growth was the same in the 1990s (at least over 1990–7) as in the 1970s (0.7 in each case), contrasting with the very high 2.6 percent of the 1980s, when bad jobs were created, and with the 0.4 percent in the 1950s and 1960s, when fast growth in relation to the number of new jobs meant that job quality was rising (figures from Stallings and Weller, 2001). The time pattern of this variable simply confirms its very limited relevance in judging the performance of the Latin American economies. Employment creation is mainly driven by the supply side—the growth of the working-age population and changes in the PR. Self-employment opportunities created by workers themselves continue to account for about a quarter of nonagricultural employment in the region.

and 2006. The methodological change that occurred in Brazil (see notes to table 4.2) may not have been taken into account by ECLAC; this would explain the difference in results, and imply that the figures are unduly pessimistic with respect to the change that has taken place.

The main indicators assessing labor-market performance should thus be job quality (especially underemployment), informality, wage levels, job security, and working conditions.

The available evidence is consistent with the hypothesis that, at least over short periods (during which changes in inequality tend to be small), the rate of economic growth is likely to be the main determinant of labor-market outcomes.²⁰ With slow output growth in most countries and with rising employment (despite some increase in unemployment), it is apparent that average labor productivity rose at a slow pace over 1991–2002 (probably by 0.7–1.1 percent per year) after a net decline between 1980 and 1990 (table 4.3). This suggests that, on average, wage earnings would be expected also to rise slowly, if at all. The positive effect of any shifts from lower- to higher-paying occupations, must have been offset by some flat or falling occupation-specific wage trends.²¹ Only Chile and the Dominican Republic,²² and perhaps Argentina, had rapid labor-productivity growth, although the figures for Argentina are highly sensitive to the years chosen. For most countries the figure is between 0 and 1 percent per year. Venezuela's was the lowest, at –1.6 percent.

Composition of employment. Two related trends are particularly worthy of note—one in the tertiary sector and the other in the informal sector. For the nine countries included in the ECLAC study referred to above, Weller (2000) finds that in the 1990–7 period, services accounted for about 91 percent of employment growth; the decline in agriculture was partially offset by the modest growth of manufacturing employment and the more significant growth of construction employment (table 4.4).

Over the longer period 1990–2002, ILO data (table 4A.3) reveal that the main sectoral shifts in the composition of nonagricultural employment involved a decline in “manufacturing, mining, and utilities” of about 2 percent

²⁰ One manifestation of this fact emerges in the correlation between growth and an index of labor performance constructed by Stallings and Weller (2001), an average of four subindices that summarize performance in terms of unemployment, real wages, employment generation, and the growth of wage jobs compared to general job growth, with best and worst performers assigned values of 1 and 0, respectively. The correlation with growth is reasonably, but not very, close, which could be due to problems with the indices or to other reasons. A close short-run relationship does not, in any case, imply an equally close long-run one, so other determinants of labor market outcomes must obviously be considered carefully.

²¹ There does not, however, appear to have been much occupational upgrading on average.

²² Assuming the figure for Brazil presented in the ILO source is in error—see table 4.3.

■ **TABLE 4.3** Average Annual Growth of GDP, Labor Force, Employment, and Labor Productivity, 1991–2002: Latin American Countries

Country	GDP	Labor force	Employment	Labor productivity
Argentina	2.0	1.6	0.5	1.5
Bolivia	3.5	3.8	3.5	0.0
Brazil	2.4	0.8	0.7	1.7
Brazil (adjusted) ^a	2.4	2.0	1.7	0.7
Chile	5.4	1.4	1.2	4.2
Colombia	2.3	2.9	2.0	0.3
Costa Rica	4.5	3.5	3.6	0.9
Dominican Republic	5.4	2.2	2.0	3.4
Ecuador	2.3	2.3	1.8	0.5
Jamaica	0.9	1.2	1.1	−0.2
Mexico	3.0	2.2	2.0	1.0
Paraguay	1.5	2.9	1.7	−0.2
Peru	3.8	2.7	2.6	1.2
Uruguay	1.2	0.5	0.1	1.1
Venezuela	1.4	3.5	3.0	−1.6
Region	2.6	1.8	1.5	1.1
Region, adjusted ^a	2.6	2.3	1.9	0.7

Source: ILO (2003), except for the adjustment to the Brazil data, discussed in table 4.2.

^a The original figure for labor-force growth in Brazil appears to be incorrect, since it is inconsistent with other available data. Hence it has been adjusted to reflect those figures, as have the numbers in the last column.

(but nearly 3 percent for males), and an increase of 2.5 percent in trade and 1.1 percent in transportation. With the agricultural sector included (its share of total employment fell from about 29 percent in 1990 to about 20 percent in 2002), the decline in the employment share of the goods-producing sectors is greater (from about 49.5 percent to 40.9 percent), though that of other tradables taken together (manufacturing, mining, utilities, and construction) changes little while the services share rises from 50.6 percent to 59.3 percent.²³

There are two especially noteworthy elements to these patterns. First, the share of employment in agriculture has continued to fall rather quickly, despite the removal of much of the protectionist apparatus usually linked to manufacturing. This is not really surprising, however, since the earlier reductions in protection (especially in Chile) did not reverse or perhaps even

²³ Estimates based on tables 4.4 and 4A.3, and on Weller (2000).

■ TABLE 4.4 Growth and Composition of Employment by Sector, 1990–7: Selected Latin American Countries

Country	Agriculture	Manufacturing	Construction	Commerce	Basic services	Financial services	Social and other services	Total
Brazil (1992–9)	-0.9 -18.0 24.2	-0.2 -1.6 12.3	2.4 11.5 6.6	2.8 26.8 13.3	3.0 8.4 4.0	5.6 14.0 3.6	2.3 58.8 36.1	1.3
Chile (1990–9)	-1.5 -12.9 14.2	0.4 3.2 16.3	3.1 11.4 8.6	3.0 29.1 18.1	3.0 12.8 8.4	7.7 24.1 6.9	2.1 32.2 27.6	2.5
Colombia	-0.5 -11.6 23.1	-1.4 -17.4 13.0	0.7 3.0 5.2	2.1 40.7 21.7	2.3 12.1 6.3	5.0 18.7 4.9	2.1 54.8 25.7	1.1
Mexico	0.0 0.2 24.2	5.1 28.8 16.6	1.8 3.4 4.7	4.3 26.4 21.5	5.1 7.5 4.6	5.6 6.0 4.1	3.7 27.7 24.4	3.1
LAC 15 countries	-0.3 -4.1 23.6	1.2 8.3 13.5	2.8 7.8 6.0	4.0 32.7 18.1	4.4 10.8 5.1	6.0 12.3 4.1	2.5 32.4 29.5	2.2

Sources: Stallings and Weller (2001) for the first two rows and Weller (2000) for the third row. In the last row the figures correspond to the nine countries for which Weller (2000) presented data rather than for the 15 for which Stallings and Weller (2001) presented data.

Note: Figures in the first row give the annual rate of growth of employment in the sector during the period. Figures in the second row give the percentage of total employment growth occurring in the sector. Figures in the third row show the percentage of each sector in total employment at the end of the period.

significantly slow this normal process of decline. Second, the manufacturing share has also been falling. The record in now-industrialized countries suggests that this latter development might not be expected so early in Latin America's economic evolution. To some extent, at least, deindustrialization has been "invited by public policy," as noted by Palma (2005).

Informality. The large increase in informality (that is, employment in establishments of five or fewer workers, in the most common definition²⁴) that characterized the crisis years of the 1980s has been widely noted in the literature. With a return to modest growth since 1990, there was hope of reversing the upward trend in the share of nonagricultural employment found in this category, and much concern has been expressed that this reversal has not occurred—although the figures do suggest that the share has leveled off since 1995 (table 4.5). Because the treatment of domestic servants is somewhat controversial, it is appropriate to keep in mind the evolution of that share of employment since it may or may not be best viewed as "informal."

An increase in informality (defined as including domestics) of 3.3 percent occurred over the first five years (1990–5), during a period of better per capita GDP growth than subsequently; there was no further significant change over 1995–2002. For 1990–2002 as a whole the informal employment share, excluding domestic service, rose 2.6 percent or more in all of the larger countries except Argentina.

The increase in informality during the early 1990s was accounted for by increases of 1.8 percent in the employment share of independent workers and 1.6 percent for domestics. Decline occurred in the share of the public sector (2 percent) and the formal private sector (1.3 percent). After 1995 the structure of regional employment was remarkably stable. The main change was a 0.8 percent increase (14.8 percent to 15.6 percent) for microenterprises and a 0.6 percent decline for domestic service. One hypothesis, though not a very plausible one, is that the concentration of the public sector shrinkage over 1990–5 may have fed indirectly into the increase in domestic service through a "bumping down" process. The latter change might also be a result of increasing income inequality and/or increases in the PRs of married women with children. Domestic service rose in Brazil, whose numbers drive

²⁴ Sources often use the term *firm* when they mean *plant*, since most data are organized by plant size. For smaller units, the two usually coincide.

■ **TABLE 4.5 Levels of Informality by Gender, 1990–2002: Latin America**
Percentages of nonagricultural labor force

Year	Informal sector				Formal sector		
	Total	Independent workers	Domestic service	Microenterprises	Total	Public sector	Private sector: all firms
1990							
Both	42.8	22.2	5.8	14.7	57.2	15.5	41.7
Men	39.4	21.6	0.5	17.3	60.0		
Women	47.4	23.2	13.8	10.4	52.6		
1995							
Both	46.1	24.0	7.4	14.8	53.9	13.5	40.4
Men	42.7	23.9	0.8	18.0	57.3		
Women	51.0	24.1	17.0	9.9	49.0		
2000							
Both	46.9	24.6	6.7	15.6	53.1	13.3	39.7
Men	44.5	25.3	0.6	18.7	55.5		
Women	50.3	23.7	15.4	11.2	49.7		
2002							
Both	46.5	23.9	6.8	15.8	53.5	13.9	39.7
Men	44.3	24.7	0.7	18.9	55.7		
Women	49.4	22.8	15.2	11.3	50.6		

Source: ILO (2003).

the regional increase in informality, but there appear to be no reliable figures on what happened to public sector employment. In Mexico, a public share decline coincided with a smaller increase in domestic service. The increase in informality was more marked for men over the whole period since 1990, since it kept rising until 2000. Over the period 1990–2002 it rose by 4.9 percent (of which 3.1 was in the independent worker category), compared with 2 percent for women, though the level of informality remained higher for the latter.

Has faster growth, where it has occurred, discouraged informality, as might be expected? Chile, Costa Rica, and the Dominican Republic, the three fastest-growing countries over this period (all above 5 percent per year), might have been expected to register declines in this indicator. In fact the level was constant in Chile, increased by 3.6 percent in Costa Rica, and possibly increased in the Dominican Republic.²⁵ There is thus no short-run link at the country

²⁵ ILO (2003) does not present data for this country but ECLAC (2004a) does, suggesting little change over 1992–2002 (though data are incomplete).

level between fast growth and declining informality, though it is true that the average increase in informality for these countries (especially if weighted by population) was lower than that for the slow-growing countries.

Overall, the main impression is of modest change in the level of informality since 1990, with most of the increases that did occur²⁶ taking place by 1995.²⁷ But the increase is not so general or large as to strongly suggest that something more than slow growth of per capita output or income has been involved. Possibly the continuing increases of the early 1990s were a legacy of the 1980s crisis, while the subsequent stability is a more accurate predictor of what might be expected of continued slow economic growth in the future.

The quicker growth pace of the informal over the formal sector in the 1990s is part of a broader pattern across the whole recorded size range, whereby employment growth has been faster the smaller the firms and plants. Stallings and Weller (2001) present 1990–8 data for 12 countries (table 4.6) showing both the rapid growth of informal employment and the faster growth of smaller firms over larger firms within the formal sector.²⁸ What underlies the faster growth of employment in smaller firms over the 1990s? Is it mainly a bad sign, indicating that because employment is not available in larger firms, these small ones (together with microenterprises) compose a safety valve where people do find work, though at lower wages and with inferior working conditions? Can it be called a good sign, indicating that productivity and competitiveness are advancing well enough in this size range to attract an increasing share of workers? Or could it be that this trend simply reflects the fact that the economies are moving toward mainly tertiary activities, in which small firms play a larger role than they do in modern manufacturing?

Two types of evidence argue for the second and more negative interpretation of this trend. First, income distribution has worsened in a number of countries. Second, as Stallings and Peres (2000) have emphasized, there

²⁶ The household surveys that provide these data are clearly subject both to sampling error and to noncomparabilities. The share of employment in categories like “professionals and technicians” moves around too much to be taken very seriously. During the period in question, it fell in Mexico, jumped wildly in Argentina, rose sharply in Costa Rica, declined in Colombia and Venezuela, and increased in Ecuador (ECLAC, 2004a).

²⁷ Although the absolute share of the labor force in informal jobs would be higher if the rural population were included, the trend would be more positive.

²⁸ For a somewhat similar set of data corresponding to wage earners in the manufacturing sector, see Weller (2000).

■ **TABLE 4.6 Growth of Urban Employment by Size of Plant, 1990–8:**
Twelve Latin American Countries

Weighted averages of 12 countries

Sector	Rate of employment growth	Contribution to growth (%) total formal/informal	
Total	2.9	100.0	
Informal sector	3.9	61.0	100.0
Self-employed	3.6	29.0	48.0
Domestic service	5.2	11.0	18.0
Microenterprise (< 6 workers)	3.8	21.0	34.0
Formal sector	2.1	39.0	100.0
Public sector	0.7	3.4	8.7
Private sector	2.6	35.6	91.3
Small (6–20 workers)	3.6	8.7	22.8
Medium-sized (21–100 workers)	2.2	11.6	29.2
Large (> 100 workers)	2.4	15.3	38.3

Sources: Stallings and Weller (2001). Figures in the second and third columns for the public sector were not presented in the source and have been added here on the assumption that in the mid-1990s this sector accounted for 14 percent of urban employment; other figures in these columns have been adjusted accordingly. Weighted averages as presented in ILO (1999).

has been a widening of the productivity gap between larger and smaller establishments in the postreform period, suggesting that the share of output may be rising—or at least not falling—in the larger firms even as their employment share slips. Such a trend leads to increasing polarization of an economy and can contribute to widening income gaps. It is one of the predictable impacts of increased pressure to raise labor productivity in larger firms that compete internationally. Though many of the qualitative aspects of this trend have been analyzed (see, especially, Katz, 2000) and are increasingly understood in Latin America, it will remain hard to pin down the longer-run implications until better data and more analysis of it are forthcoming.

A major question is whether some or most of the Latin American economies can take advantage of increasing openness to multiply the quantity of good jobs as a number of their East Asian counterparts have done, by hooking relatively labor-intensive smaller firms onto the production of exports and of import-competing goods. South Korea and Taiwan are classic cases in which the export sector created more employment opportunities, either directly (especially in Taiwan, as SMEs produced and exported) or indirectly (notably in South Korea, where large firms handled the great bulk of manufacturing

exports but subcontracted a high share of value-added back to smaller firms, following the pattern that had been adopted earlier in Japan) (Berry, 1997b). These countries typically used a combination of policies to provide a good deal of effective protection to local producers for the domestic market, in which it is generally easier to compete without becoming large. The lack of detailed data leaves it unclear whether there is a trend in Latin America toward indirectly incorporating smaller firms into the export process by subcontracting. The conventional wisdom is that this phenomenon is much less present in the region than it has been in East Asia. It is necessary to identify current trends so as to better understand what is happening and to build SME policy around that understanding.

Wages—absolute and relative. Data on wage trends come mainly from three sources: data reported by firms on their regular payroll employees, special surveys of specific groups of workers, and household surveys that identify the employment sector of respondents and provide wage information. Together they can provide a wealth of information on labor-force outcomes, but they are very seldom analyzed holistically. In principle, the most useful wage series—as indicators of the quality of labor-market outcomes—are probably those for agriculture and construction. The former remains the largest single sector of employment in most countries, while many relatively unskilled male workers are hired in construction in a relatively competitive market, such that the resulting wage provides valuable information on job prospects for the broader category of relatively low-skilled workers of which they are a part. The two wage series often move together because of the mobility of workers between the two sectors. Unfortunately, reliable and comparable wage data for agriculture and construction are not available for enough countries to make them readily usable here.

Manufacturing sector data are better. Figures from the ILO (2003) reveal a 12.6 percent increase for the region as a whole over 1990–2003, though with highly disparate patterns ranging from the 46.2 percent increase in Chile to a 39.1 percent fall in Venezuela (table 4.7). Among those countries whose figures cover most of the period 1980–2003 there were major net declines in Argentina, Mexico, Peru, and Venezuela; a modest increase in Brazil; and large increases for Chile, Colombia, and Costa Rica.²⁹ The regional trend over the

²⁹ As usual, there are likely to be data quality problems in some of these series.

■ **TABLE 4.7 Real Manufacturing Wages, 1977–2002: Latin America and Selected Countries**

1990 = 100

Year	Argentina	Brazil	Chile	Colombia	Costa Rica	Ecuador	Mexico	Peru	Venezuela	Latin America
1977	100.0	—	76.2	72.4	100.0	—	146.6	279.5	—	—
1980	126.6	—	95.2	86.2	114.9	—	140.0	256.4	217.4	—
1986	139.2	105.2	89.5	99.1	109.2	—	98.6	251.2	184.8	—
1990	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1991	101.4	94.0	106.7	99.4	96.7	104.6	103.9	118.2	91.4	97.9
1992	102.6	101.7	111.7	100.7	97.3	113.5	113.4	113.6	87.1	103.5
1993	101.0	112.4	115.7	105.4	112.1	127.7	116.7	111.0	82.2	109.3
1994	98.9	117.3	121.5	106.3	114.6	139.0	119.9	131.4	85.8	112.7
1995	97.7	128.4	128.5	107.7	112.0	152.9	101.1	126.4	80.7	114.0
1996	98.2	132.8	132.9	109.1	110.2	161.2	92.6	123.2	68.1	113.9
1997	94.5	137.4	138.8	112.3	115.0	157.5	94.4	122.9	85.5	117.3
1998	94.0	140.3	142.0	112.5	119.1	151.2	97.7	125.1	90.1	119.5
1999	94.5	135.3	143.7	114.3	124.3	138.7	100.9	122.5	81.5	117.3
2000	95.8	133.2	144.2	118.6	137.0	132.1	107.9	123.2	82.8	118.4
2001	94.4	135.1	144.8	119.1	137.2	134.7	114.0	126.1	84.7	121.3
2002	76.1	131.6	146.6	122.2	—	161.0	117.1	126.8	75.9	118.3
2003 ^a	65.4	123.8	146.2	121.6	—	152.6	118.7	134.3	60.9	112.6

Sources: Cox Edwards (1992, table 1) for data before 1990; for data from 1990 onward, ILO (2003). For weighted averages, ILO (2003). Source does not indicate country weights.

Note: Weighted averages include several small countries whose data are not presented in this table. — = data not available.

^a Up to the third quarter.

1980s is unclear since figures for major Brazilian cities behave surprisingly differently, leaving some ambiguity as to the average trend in that country.

Has the high and rising importance of the informal sector in urban employment produced a widening gap between informal and formal sector incomes, as might be expected if the former is primarily a safety valve or last resort for job seekers—or even if, independent of such a pattern, the informal sector has trouble raising labor productivity to keep pace with the formal sector? Do any trends in relative earnings match the periodicity of changes in the informal sector's employment share—upward in 1990–5 and then about constant?

For the whole formal sector, Weller (2000) shows moderate wage increases for the region over 1991–8, driven by a rise of 29 percent in Chile, 24.5 percent in Brazil, and 11.3 percent in Colombia; bigger increases in several small countries (Bolivia, Costa Rica, and Jamaica); and small decreases in Mexico, Argentina, and Peru. Relative to 1980 figures, Chile and Bolivia remain big winners, Brazil and Colombia modest ones, Argentina (23.8 percent) and Mexico (19 percent) significant losers, and Peru a total loser (65 percent). Weighting the nine countries that Weller included in his study by population gives a net loss over 1980–98 of 8.4 percent and a gain of 7 percent over 1990–8—considerably smaller than the 19.5 percent increase in manufacturing wages over those same years.

The declining relative share of employment in the formal sector is probably tied to the greater increase in manufacturing than in all formal sector wages, as international competition (and perhaps other forces) eliminate some of the less productive and lower-wage manufacturing firms. As of 1998 the gains over 1990–8 had not yet offset the 17 percent loss between 1980 and 1990. Judging by the decline of 5.8 percent in manufacturing wages over 1998–2003, it is therefore probable that, as of 2003, formal sector wages for the region remained about 15 percent below their 1980 level. This decline is not much greater than that of regional GDP per worker (table 4.8), which by 2003 was about 8 percent below the 1980 level and seems to be quite close to that of national income per employed worker. When these two figures are close to each other, the implication is that the labor share of national income did not change significantly, since it is the trend of labor income per worker that should match the trend of wages/earnings from labor.

The importance of knowing the income trends in the urban informal sector depends both on its size and on the magnitude of its income gap vis-à-vis the formal sector. This gap typically falls in the range 20–60 percent

■ **TABLE 4.8 Aggregate Indicators of Economic Growth, 1980–2003:**
Latin America
1980 = 100

Variable	1980 (index)	1980–90 average annual growth	1990 (index)	1990–2003 average annual growth	2003 (index)
GDP: ECLAC	100.0	1.18	112.5		
World Bank	100.0	1.50	116.1	2.70	164.2
GDP per capita: ECLAC	100.0	–0.85	91.8		
World Bank	100.0			1.11	
National income	100.0	0.60	106.2		
National income per capita	100.0	–1.44	86.5		
Population	100.0	2.05	122.7	1.57	150.3
Labor force	100.0	3.00	134.4	2.44 ^a	183.8
Open unemployment (%)					
Urban	6.7		5.7		9.2 ^b
Total ^c	5.5		4.9		8.1 ^b
Employment	100.0		135.3		178.8
Labor productivity (World Bank)	100.0		85.8		91.8
National income/worker (ECLAC)	100.0		78.5		

Sources: ECLAC (1995), World Bank (2005).

Note: Blank spaces in table indicate lack of available data.

^a Based on Figure 2.5 in World Bank (2001) for 1990–9 and a guess that the figure for 1999–2003 would be about 2.3 percent (based in part on Weller, 2000).

^b Adjusted from the new ILO series (ILO, 2003) to the old one to maintain comparability with the earlier figures.

^c Based on the assumption that open unemployment was half as high in rural as in urban areas, and taking account of the changing share of total employment that is rural.

(of formal sector earnings) depending on the country and the concepts used (for example, whether only paid workers are included, whether the informal sector is defined to include plants of fewer than six workers, or in some other way).³⁰ Usually, the average earnings gap between the two sectors substantially overstates the gap for “like workers”; thus, when characteristics such as education are held constant, earnings functions tend to show a differential of 25 percent or so. With a modest gap like this, as Maloney (2004) and others

³⁰ In Venezuela, taking a 1980–92 average, paid workers in the informal sector earned 26.3 percent less than their formal-sector counterparts (Rodríguez and others, 1995). Elsewhere, the gap can be considerably greater, as shown by the data in table 4.9.

have pointed out, there is a substantial voluntary flow of people from the formal to the informal sector and in the opposite direction. This is part of the considerable labor mobility observed especially for younger workers and those at a stage of their careers at which they may, for example, wish to go into business for themselves.

Though differences in personal characteristics explain much of the average informal/formal sector income gap, sudden changes in that gap are likely to be token changes in the gap for “like workers.” Even where this is not the case, changes in the average income gap reveal something about the relative economic welfare of the two groups. For the period 1990–2002, the figures available for nine countries (table 4.9) point to a general and usually sharp widening of the earnings gap between informal and formal sector workers (including the self-employed).

Of these countries, only in Brazil, Costa Rica, and Ecuador did the ratio fall by less than 10 percent; in extreme cases like Argentina and Bolivia it fell by more than 20 percent.³¹ In both cases, the relative income loss of nonprofessional, nontechnical independent workers was behind this result. This category is especially large in Bolivia’s informal sector.

More generally, the falling relative income of independent nonprofessional/nontechnical workers has featured in most cases where informal workers as a whole have lost ground (table 4.10).³² Relative informal sector income fell by less than 7 percent in three of the countries listed: the relative income of independent workers rose in Ecuador, fell by a small amount in Brazil, and fell markedly in Costa Rica but with a muted impact because of the relatively small weight of this category. In the other six cases where the relative decline of informal worker incomes was 12 percent or more, independent workers were also major losers (relative to average incomes) in all cases except Venezuela. To a large extent this association is a simple mechanical result of the fact that independent workers usually compose over half of all informal sector workers. Meanwhile, a comparison between informal and formal sector paid workers who are not professionals or technicians shows a much less marked negative tendency: in three countries the ratio was unchanged (including

³¹ Given possible data problems and lack of comparability over time, the numbers may be somewhat imprecise, but it is very unlikely that the large changes shown for so many countries are a statistical illusion.

³² To the extent that this is the case, even evidence that informal sector wages are moving more or less in parallel with formal sector wages would not by itself be cause for much complacency.

■ **TABLE 4.9 Informal/Formal Sector Earnings Levels and Differences, 1990–2003, Urban Areas: Selected Latin American Countries**

Country	Years	Informal sector ^a (1)	Formal sector ^a (2)	Ratio informal/formal (3)	Ratio informal/formal (paid nonprofessional, nontechnical workers only) (4)
Argentina	1990	5.50	7.01	0.784	0.800
	2002	2.96	5.77	0.513	0.680
Bolivia	1989	3.36	5.29	0.635	0.740
	2002	2.01	5.21	0.386	0.600
Brazil ^b	1990	2.73	6.15	0.443	0.680
	2001	2.29	6.02	0.380	0.680
Chile	1990	3.65	5.31	0.687	0.685
	2003	4.30	8.50	0.506	0.725
Colombia ^c	1991	2.02	3.84	0.526	0.830
	2002	1.85	4.91	0.376	0.840
Costa Rica	1990	3.00	6.22	0.453	0.740
	2002	3.16	8.12	0.389	0.630
Ecuador	1990	1.89	3.72	0.508	0.790
	2002	2.24	4.79	0.468	0.620
Mexico ^b	1989	3.07	5.23	0.586	0.610
	2002	2.56	5.24	0.462	0.640
Venezuela	1990	3.55	4.99	0.711	0.690
	2003	2.48	4.26	0.582	0.680

Sources: Except where noted, ECLAC (2004a). Details of coverage vary somewhat across countries—see source.

^a Figures are expressed as multiples of the respective per capita poverty lines.

^b Figures for Brazil and Mexico in 1989 combine average income by category from ECLAC (2003), with figures on employment share from ILO (2003), even though, as noted with respect to table 4.3, the employment share figures for the latter source appear to be unreliable. This may make the average income figures also incorrect, in which case the same will be true of the figures presented here.

^c Figures for the share of paid workers in microenterprises are not available in ECLAC (2004a). Figures have been interpolated from ILO (2003). Average earnings of that category are assumed to be three-quarters as large as for comparable workers in larger firms, on the basis of the typical ratio for other countries.

cases of a change of no more than 1 percent), in two countries it rose, and in three countries it fell (of which only Argentina was a large country). For these two relatively comparable groups, therefore, a weighted average across the countries reveals very little change over this period.³³

³³ Saavedra (2003) also presents both formal and informal sector wage trends over 1990–8 for several countries. Coverage varies (for example, sometimes white-collar workers are included and sometimes not) and comparability is thus imperfect. Although there are cases where formal and informal wages do

■ TABLE 4.10 Falling Relative Incomes of Nonprofessional, Nontechnical Independent Workers, Urban Areas, 1990–2003: Selected Countries

Country/ year	Employers, average level	Public sector workers, average level	Private sector professional and technical workers, average level	Independent workers, ^a average level	Independent workers/public sector	Independent private professional and technical workers	Female workers/male workers
Argentina							
1990	3.21	—	1.47	1.125	—	0.766	0.64
2002	4.45	0.702	1.43	0.872	1.24	0.612	0.57
Bolivia							
1989	3.86	0.978	1.830	0.905	0.927	0.494	0.57
2002	2.28	1.625	2.401	0.593	0.365	0.247	0.57
Brazil							
1990	3.43	—	1.745	0.723	—	0.415	0.54
2001	3.44	0.814	1.605	0.651	0.418	0.405	0.63
Chile							
1990	5.28	—	1.574	1.064	—	0.743	0.53
2003	4.96	1.055	1.685	0.795	0.753	0.472	0.65
Colombia							
1991	2.55	1.345	1.828	0.759	0.564	0.415	0.66
2002	2.40	2.130	2.100	0.500	0.234	0.238	0.74
Costa Rica							
1990	1.31	1.40	1.73	0.653	0.466	0.378	0.69
2002	1.57	1.46	1.49	0.477	0.326	0.320	0.74
Ecuador							
1990	1.71	1.46	2.14	0.679	0.463	0.317	0.61
2002	2.49	1.34	1.43	0.686	0.511	0.480	0.63
Mexico							
1989	4.93	—	1.57	1.000	—	0.638	0.55
2002	3.93	1.32	1.73	0.780	0.593	0.451	0.59
Venezuela							
1990	2.64	0.889	1.47	0.956	1.075	0.652	0.65
2002	3.00	1.360	1.45	0.848	0.622	0.583	0.78

Source: Table 4A.5.

Note: — = data not available.

^a Excluding professionals and technical workers. Figures refer to relative mean incomes of selected groups of earners.

Like several other aspects of the recent record in Latin American labor markets, the falling relative income of independent workers can be interpreted in more than one way and therefore needs to be analyzed carefully to draw out its true implications. A negative reading is that independent workers compose a marginal group in a developing economy and either a rise in their employment share or a fall in their relative income reflects a polarizing economy—one marked by too little creation of decent jobs—and portends a worsening of income distribution. This category of workers can be thought of as the closest to a “surplus labor” group in an economy, with their income reflecting the marginal product of their labor. When that income falls, it means that, overall, the economy is failing at the margin. But this is not necessarily the full or even a significant part of the full story. It might be expected that a general flooding of the informal sector would pull down relative earnings of paid informal sector workers by more than what appears to have happened, simultaneous with the impact on independent workers. That this did not happen reduces the persuasiveness of the argument. Nor does the relative decline for this group seem to be gender related.

It is also clear that the independent worker category (even when professionals and technicians are excluded, as they are here) includes a good number of the nonpoor; in some countries and some years, their average income equals or exceeds the national average (for example, Mexico, 1989; Argentina, 1990; Chile, 1990). It may also be that a sizeable share of independents work part time by preference, which would help explain their low income, or they may be providing secondary earnings in their families. If these situations are common, the falling relative income trend of this group is of less social concern. Further analysis would be required to ascertain the place in the income distribution of the individuals in this category whose incomes have

not move in close parallel over short periods, wages in both sectors show large net increases in Bolivia and large decreases in Venezuela, with neither sector showing much net change in Ecuador, Peru, or Colombia (though formal wages did rise faster) and Argentina (where informal incomes rose somewhat faster). In some countries the direction of change appears to be different from that in the figures used here, and since the sample does not include the region's two largest countries, these data could not shed much light on the state of regional informal sector wages. The lack of any significant pattern of decline in the wages of informal sector workers relative to those of formal sector workers is roughly consistent with the figures here over the longer period, including up to about 2002 in most countries, although for the countries included in both samples (which excludes the two largest ones) the data here show a more general downward trend that could be due to the different periods chosen or to other factors.

fallen the most, particularly in those countries where the group's average income is not too low relative to that of all earners.

Pending such detailed analysis, a comparison of trends in informal/formal and independent worker/average incomes and trends in overall income inequality suggests that a widening of such gaps does not necessarily portend distributional disaster. Although the widening of the informal/formal gap in Argentina did coincide with a sharp increase in income inequality, in Bolivia the increase in inequality was moderate, in Chile and Colombia it was small or absent, in Ecuador a very small increase in the gap went with a significant rise in inequality, and in Mexico a substantial increase went with a reported decrease in inequality.

Part of the widening informal/formal earnings gaps is likely to be associated with the much remarked-upon widening of the gap by skill or educational level. That trend was evident in the first part of the 1990s, the period during which increases in the rate of informality were concentrated. For seven countries (weighting by population) the average gap in earnings across the entire educational spectrum (that is, comparing university graduates to people with 0–3 years of schooling) widened from 5.36 to 6.12, while the earnings ratio of university graduates to lower secondary school graduates rose from 3.67 to 4.21 (table 4A.6). An important issue related to the rising earnings gaps is the extent to which they may be the result of too slow an advance in educational attainment, measured either in quantity or in quality.³⁴ IDB (1999) argues that “the average education of the workforce has advanced more slowly than it has elsewhere in the world, and by the early 1990s it had not even reached five years of schooling.” This important hypothesis warrants further attention, both in explaining the region's slow growth performance since 1990 and the negative income-distribution outcomes, and in considering the impact of liberalization on these outcomes.

The available data on how net enrollment rates³⁵ have been changing at the secondary level reveal no clear difference, over the period 1980–97,

³⁴ It is also possible that a rising quality gap between higher and lower levels of education might be showing up in the widening earnings gap, since quality of education is not taken into account in most earnings calculations.

³⁵ Data on enrollment ratios suffer from a wide range of problems. Gross enrollment ratios (number enrolled divided by the estimated number of students in the normal age range for enrollment at that level of education) are biased because of errors in numerators and denominators and because high repetition rates raise the estimated ratios. Net enrollment rates (the share of children of a specific age who are in

between Latin America and the Caribbean (LAC) and the developing world as a whole (table 4.11). That ratio rose by 11 percent in the region compared to 10 percent for all middle- and low-income countries together, and just 8 percent for East Asia. Except for China, whose increase was only 7 percent, the other fast growers of East Asia did display dramatic increases of 14–24 percent; most were somewhat or well behind LAC in 1980, the exceptions being China and South Korea. In terms of the share of GDP spent by the public sector on education, the World Bank figures in the table point to a small decline in LAC, though the only region with a big increase was South Asia.³⁶

IDB (1999) estimates that the average years of schooling of people aged 25 years and more in the LAC region rose from 3.3 in 1970 to 4.8 by the early 1990s.³⁷ The proportion who were illiterate fell from 36 percent to 23 percent, and those with some university education rose from 2 percent to more than 8 percent. The study contrasts this advance with that of the Asian “miracle” countries, where the average schooling of those 25 and above was 3.5 years in the 1970s but reached over 6 years by the early 1990s, or an increase of 3 percent per year as against the 0.9 percent estimated for LAC. This gap appears to be somewhat overestimated—judging by recent ECLAC figures—though doubtless it is substantial.³⁸ The authors also note that income inequality is associated with schooling inequality and that the variance of years of schooling has tended to increase in LAC countries.

It seems likely that faster growth of educational attainment would have had some growth benefits in LAC countries, and that a reduction in educa-

school) are more reliable but less commonly available (UNDP, 2002). Only when demographic, educational, and household survey data are cross-checked for consistency can the figures be presumed to be close to accurate.

³⁶ Figures on educational expenditures are often unreliable and should be taken with some caution.

³⁷ As of the early 1990s, average years of schooling estimates range from under three years in Guatemala and Haiti to over nine years in Chile. The weighted average of 4.8 years reflects the low levels in Mexico (just over five years) and Brazil (less than five).

³⁸ The partial figures presented in table 4A.9, allowing for changes in the urban to rural population ratios over time, suggest annual growth rates of this variable of something over 1 percent but under 2 percent per year. There is a considerable level of uncertainty for the region as a whole, since data for Mexico before 2002 are not comparable, as indicated by the source. Among the large countries, only Brazil, Argentina, and Colombia (and for Argentina and Colombia only in urban areas) have data over the two decades. In each of these cases, the annual increase in average years appears to be around 1.5–1.7 percent. For Venezuela, Costa Rica, and Chile it is a little over 1 percent. Meanwhile, the mean years by birth cohort rose from about 4 for those born around 1930 (who hence finished education by about 1950) to about 8 for the 1970 cohort, with a recent slowdown in growth after the early 1960s cohort. This constitutes a growth of about 1.75 percent per year over this 40-year span.

■ **TABLE 4.11 Comparative Educational Indicators by Region, 1980 and 1997**

Region or country	Public expenditure on education as % of GDP		Net enrollment ratio, secondary school	
	1980	1997	1980	1997
Low- and middle-income countries	3.5	4.1	53	63
East Asia and Pacific	2.5	2.9	59	67
Middle East and North Africa	5.0	5.2	46	66
South Asia	2.0	3.1	38	55
Sub-Saharan Africa	3.8	4.1	—	—
Latin America and the Caribbean	3.8	3.6	55	66
Fast-growing East Asian countries				
South Korea	3.7	3.7	76	100
Thailand	3.4	4.8	25	48
Malaysia	6.0	4.9	48	64
Indonesia	1.7	1.4	42	56
China	2.5	2.3	63	70
Other				
India	3.0	3.2	41	60

Source: World Bank (2001).

Note: — = data not available.

tional inequality would have reduced income inequality, but the magnitude of such effects is far from clear in theory or in observed outcomes. The rapid adoption of new skill-intensive technologies does mean that if the supply of the relevant skills fails to grow, earnings gaps will widen. And the adoption of new technologies disproportionately in the early 1990s—as the economies started to grow and imports became increasingly available—does match the fact that informality rose then but not later. Increases in inequality since 1990 are not particularly concentrated in one part of that period (see table 4A.8), though this could be due to varying lags between adoption of new technology and the labor-market impacts. A serious assessment of the hypothesis of the IDB (1999) requires much greater knowledge of how education pays off, why and how much quality matters, and so on.

One of the most striking aspects of labor-market outcomes during the period since 1990 is the rising female PR. This increase does not appear to have led to any general increase in female unemployment rates relative to those of males, nor to a fall in women's relative earnings. In fact, mean male-female hourly wage gaps in urban areas are now surprisingly small.

Figures for the late 1990s (World Bank, 2005) reveal female-to-male ratios ranging from a low of 65 percent in Nicaragua and 75 percent in El Salvador to over 100 percent in Costa Rica and about 100 percent in Argentina. Of the 12 countries studied, only the former two Central American countries had ratios significantly below 80 percent; the average appears to be about 85 percent, which compares favorably to the 78 percent for the United States in 2002 (World Bank, 2005). The ratio is higher still for median incomes in most countries.

Two caveats should accompany the interpretation of these numbers. First, weekly earnings gaps are wider than hourly ones because men work more hours than women on average. To the extent that this outcome is due to choice, the differences in hourly incomes are the more relevant indicator of the degree of discrimination in the labor market. To the extent that there is more involuntary underemployment among women, the weekly differentials could be more relevant. Second, because female participation is strongly associated with level of education, and sometimes also with ethnic group, the differentials may be considerably greater for comparable educational and ethnic groups. The gender wage gaps appear to have fallen over time in some countries but seem to have held constant or even increased in others. Table 4.12 presents figures for selected countries from the 1980s and the late 1990s.³⁹ Data comparing relative earnings (including the self-employed) in 1990 and 2002 or thereabouts (table 4.10) show a larger gender gap, as expected, but they also show a clear pattern of narrowing. The gap shrinks in seven of the nine countries, including Brazil and Mexico (the biggest), remains constant in Bolivia, and widens only in Argentina.

The relative advance of female earnings (referring to all workers, paid or not) and, for paid workers, the moderate wage gaps in hourly earnings as of the late 1990s, together with the very rapid increase in female PRs, indicate a marked increase in women's share of urban income (and hence of total income) in the Latin American economies. In Mexico, for example, where female participation rose dramatically and relative income rose a little, women's implicit share of total (reported) urban income rose from about 19 percent in

³⁹ Psacharopoulos and Tzannatos (1992) is the source of the earlier data. Unfortunately these authors do not make clear whether the figures they present are urban or national. The sort of information used is seldom available at a national level and is therefore presumably urban. They do point out (p. 199) that workers engaged in the formal sector may be overrepresented in the databases.

■ **TABLE 4.12 Gender Wage Gaps over Time (1980s and 1990s): Selected Countries**

Average female wage as percentage of average male wage

Country	Early gap		Recent gap
	Weekly or monthly wage gap (%)	Hourly wage gap (%)	Hourly wage gap (%)
Argentina	64.5 (1985)	79.9 (1985)	97.0 (1997)
Bolivia	62.3 (1989)	72.3 (1976)	—
Brazil	61.2 (1980)	—	77.0 (1998)
Chile	65.4 (1987)	—	77.0 (1998)
Colombia	84.6 (1988)	91.6 (1988)	84.0 (1998)
Costa Rica	80.8 (1989)	95.0 (1989)	105.0 (1998)
Ecuador	63.7 (1987)	—	—
Honduras	81.3 (1989)	85.0 (1989)	83.0 (1998)
Mexico	85.6 (1984)	—	89.0 (1999)
Peru	65.7 (1990)	—	80.0 (1997)

Sources: Columns 1 and 2 from Psacharopoulos and Tzannatos (1992). Where there were data on hours per week by gender, the gaps of column 1 were converted into those of column 2. Column 3 is from de Ferranti and others (2004). Figures shown are approximations read off the graph in the source.

Note: — = data not available.

1989 to about 25 percent in 2002—from a little less than a fifth to a quarter of the total. The increase was on a similar scale in several other countries: Brazil, Chile, Colombia, and especially Venezuela, where the rise was from 24 percent in 1990 to 34 percent in 2003. None of this is to deny that many women remain seriously disadvantaged in the labor market and in other ways, as emphasized by many authors (for example, ECLAC, 2000b).

What accounts for this relatively positive evolution of labor-market outcomes for women? The likely factors include an increase in their relative amounts of human capital in the labor force; greater continuity of female employment as PRs rise for middle-aged women and, thus, reduce the income loss from incomplete labor-market attachment; and, perhaps, changes in the sectoral composition of employment. Though a relative shrinkage of the public sector might be expected to have a larger negative impact on women, and though their share of public employment has fallen in some cases (for example, Mexico), it has risen in others (for example, Colombia), and hence the overall impact of this factor is unclear. At the same time, the decline in manufacturing's share of total employment may have been more detrimental

to men. Many private service sectors have high complements of female workers. This bright spot in the recent evolution of Latin America's labor markets deserves further analysis.

Another long-standing structural inequity is by ethnic group. Psacharopoulos and Patrinos (1994) provide an organized review of economic differences by ethnic group in four countries of Latin America. In each case, the earnings of indigenous people are significantly lower than those of the nonindigenous, partly because of differences in educational levels and partly for other reasons. Whether discrimination takes the form of different earnings for the same productivity-related attributes or of differences in endowments of those attributes through discrimination in the provision of certain services matters more for the type of remedial action needed than for whether action is needed.⁴⁰

It is equally important to know current and recent trends. Over the long run, educational levels appear to have been rising for all ethnic groups in all countries. In Mexico, the average years of schooling for educational cohorts before 1930 were about one year for indigenous people and three years for nonindigenous people; by the 1960s the averages were a little over four and a little over eight years, respectively (Panagides, 1994). In Peru the 1930–4 cohort averaged about five years for indigenous people and about seven for nonindigenous, while the 1970–4 cohort averaged about 7.5 years for the indigenous and 9.5 for nonindigenous (Macisaac, 1994). Reliable data for recent cohorts are harder to obtain since they await population censuses conducted after a cohort has passed through the years of school attendance. There is thus little, if any, current evidence on whether ethnic gaps have been widening or narrowing over the last two decades.

Underemployment, job security, pensions, and working conditions. Given the dramatic evidence of the degree to which employment insecurity impinges on the welfare of Latin Americans, it is essential to look at the evidence bearing on this insecurity. Data on underemployment (people working fewer hours than they desire) are not available on an organized basis for the region. In general,

⁴⁰ De Ferranti and others (2004) point out that wage differentials between racial and ethnic groups are driven more by differences in productivity-related characteristics (like education and place of residence) than by differences in the returns to those characteristics. Place of residence becomes important where, as is usually the case, indigenous groups are more likely to live far from the growth poles of the economy and receive less public support to increase their human capital.

underemployment rates move with open unemployment rates.⁴¹ Since both reflect the overall state of the economy,⁴² it is likely that there has been some upward trend for the region as a whole since 1990 and a decline in the last few years. To some extent, underemployment is associated with part-time employment and with job insecurity or temporary contracts, both of which have been on the rise since at least the early 1980s in many countries of the region.⁴³

In terms of job quality, there is also evidence of negative trends observed. Saavedra (2003) notes that, along with the rising employment share of the informal sector, a growing proportion of workers have neither health nor pension benefits, the turnover rates in the formal sector have risen, and temporary contracts have increased. Coupled with a lack of social benefits and stagnant real wages, the growing instability of employment is worrisome and touches not only the traditional lower economic classes but also many of those who used to be in the middle class.

How widespread have these trends been? The share of wage and salary workers with contracts varies widely from around 25 percent in Nicaragua and Peru to over three-quarters (for example, 77.3 percent in Chile in 2000). The share with “unlimited” contracts (that is, contracts that might be considered permanent) is lower and sometimes much lower: in Bolivia, 40.7 percent had contracts in 2002 but only 21 percent had unlimited contracts (ILO, 2003). In most countries for which the ILO presents data, the share of female employees with contracts exceeds that of males (for example, 51 percent to 36.2 percent in Bolivia). More striking is the gap between small and large private establishments on the one hand and between these and the public sector on the other. In Mexico, for instance, just 10.4 percent of small-establishment employees had contracts, while 64.7 percent of employees in large establishments and 92.3 percent of public sector workers did (table 4A.7). In Chile, by contrast, small establishments are relatively well covered (over 50 percent) compared to the other countries in this sample and particularly to Mexico, which has a comparable level of per capita income.

⁴¹ Tenjo (2002) shows the very tight association between the two rates in Colombia's seven largest cities over 1990–9.

⁴² The tendency of underemployment and open unemployment to move in a countercyclical manner is noted by Horton and others (1994).

⁴³ In Peru, the ratio of temporary workers to salaried formal-sector private workers rose from about 15.5 percent in 1990 to a little under 19 percent in 2000 (Saavedra, 2003). In Colombia the ratio of temporary to all workers appears to have fluctuated rather wildly, while registering a net increase over 1990–7 (Reyes, 2000).

The share of paid workers with employment contracts appears to have been stable in the latter part of the 1990s in those countries for which the ILO (2003) presents data. None of the seven countries shows a variation of more than 1.5 percent over the four- or six-year periods covered. In the early 1990s, however, there appears to have been a general decline, often of 3–6 percent (Weller, 2000). This is presumably related to the increase in informality at the time.

The pattern is broadly similar for retirement and pension benefits (table 4A.8). Overall coverage varies from 11 percent of active workers in Bolivia (2002) to 64 percent in Chile (2000). Retirement benefits, as always, are more prevalent for public sector and large private establishments, but here a significant share of the smaller-establishment employees are covered in some countries, notably Chile, Brazil, and Argentina (among those included in the data). In the first two cases the share reaches half for paid workers and 15–20 percent for unskilled self-employed workers.

For workers over 65, the largest percentage receiving a pension is in Brazil (85.3 percent in 2001) and Argentina (68.5 percent in 2001, down from 72.6 percent in 1992). In Chile, there was a sharp increase from 49.3 percent in 1996 to 62.7 percent in 2000 (ILO, 2003). In most countries there is a substantial urban-rural gap in the share of this group receiving a pension, although in Brazil the percentage is actually higher in rural areas. This presumably stems from the pension system introduced in the early 1990s, which covered agricultural workers even if they had not made contributions earlier. Between 1996 and 2000, as the share covered in Chile rose overall, the increase was especially marked in rural areas, thereby narrowing the rural-urban gap to just 5 percent. Bolivia, Ecuador, Nicaragua, and Peru were probably more typical, in that very few rural retired people received pensions—the highest figure for these countries was Peru at 12.4 percent in 2000.

Current patterns and recent trends in the level of worker protection and fringe benefits must be seen against a historical background of high levels of legislated benefits but much lower levels of *de facto* benefits because of government inability or unwillingness to implement certain labor laws. Not surprisingly, most of the large informal sector falls outside these legislated benefits and protections. In terms of the body of labor regulations, Latin American countries rank above other developing regions and even the industrial countries and are second only to Eastern Europe and Central Asia (Pagés, 2004).

Legislated social security benefits, by contrast, are lower than in industrial countries, though higher than those in other developing regions. Legislated job security, as measured by a synthetic index incorporating aspects of the regulations, is highest for this region, well above the industrial countries of Europe and far above the Anglo-Saxon developed countries. With respect to trends, Pagés (2004) contends that:

Contrary to common belief, employment protection for permanent workers did not weaken in most countries in the 1990s. In Chile, Brazil and the Dominican Republic, at the beginning of the 1990s and later in Nicaragua (1996), reforms aimed at restoring the political balance after military regimes produced more protective labor regulations. In Chile, in 1990 a new law increased maximum indemnities from five to eleven months of pay. It also reinforced the need for firms to prove just cause for dismissal although, unlike the case in other countries, the new law considered the economic needs of the firm a just cause.

Various other authors have also argued that labor law did not change much in Latin America during the 1990s and that not all of the changes resulted in weakening the legislation (Saavedra, 2003). Job security was indeed reduced in some countries (as in the Peruvian reform of 1999). Severance pay was cut in a number of cases, though it was increased in Brazil as a result of the 1988 constitution (Pagés, 2004). Weeks (1999), on the other hand, argues that “liberalized trading regimes for the countries of Latin America have so far been associated with the reduction of workers’ rights and the concentration of wealth. If this is to change in the future, a growing labor movement is required in order to ensure effective collective bargaining.”

Union density fell markedly in most countries during the 1980s. Saavedra (2003) reports the following declines between 1980 and 1990 in the share of the unionized nonagricultural labor force: from just under 50 percent to about 25 percent in Argentina, from about 55 percent to about 39 percent in Mexico, and from about 23 percent to about 5 percent in Peru. There were also declines in Venezuela and Colombia, but an increase in Chile from about 12 percent to about 15 percent. Data on more recent trends could not be located for this study.

Clearly, it is not easy to generalize about trends in labor-market institutions—unions and their strength, labor legislation and its application, and so on.

Probably more relevant than the trends of the 1990s and the present decade are the nature and direction of changes since the onset of the 1980s crisis. That crisis naturally proved a shock to workers, as real wages fell in many cases, sometimes dramatically, and as the capacity to uphold other “rights” was weakened. No attempt has been made here to summarize the relevant literature. The complexity of the issues makes it almost a foregone conclusion that no very reliable conclusions have been reached on the normative questions of what works best, if only because it is so hard to obtain reliable quantitative information on how institutions actually work, as opposed to what is in the legislation.

As noted above, one of the problems in interpreting the labor-market performance of the 1990s, and in particular the impact that openness and the reforms may have had on it, is that with overall growth as slow as it has been, and growth in output per worker marginal (about half of 1 percent according to table 4.8), it would not be unusual, judging by the experiences of other countries, for wages to fall slightly, for formal sector employment to decline as a share of urban employment, and for the informal sector to grow. Such labor-market outcomes, in other words, might reflect nothing more than “too slow growth.” Those forms of labor protection that are heavily dependent on a worker’s being in the medium-/large-scale urban sector would also not be expected to advance much, if at all, during such a period.

The trends in the few fast-growing countries are noteworthy. In Chile, the indicators reviewed above tell a generally positive story, supporting the view that elsewhere the slow growth was a major factor in reducing coverage or impeding progress in it. Still, for some variables in some countries, policy changes clearly played a role as well.

What Has Happened to the Distribution of Labor Incomes?

We have argued that the distribution of labor earnings is the best simple overall yardstick of labor-market outcomes, reflecting both their average level and their dispersion or inequality. Correspondingly, the best yardstick of the welfare implications of those labor-market outcomes would be the distribution of per capita household income. Available data on income distribution for Latin American countries mainly reflect labor earnings because of the incomplete coverage of capital incomes. Although for most countries the data suffer from

a variety of other flaws,⁴⁴ significant changes in reported inequality are likely to correspond to actual changes in the distribution of labor incomes. Data for the major countries are summarized in table 4A.10.⁴⁵ Since 1990 (or a more recent year in some countries), inequality has increased in seven countries, has decreased in two, and did not change significantly in two. A weighted average between the first recorded Gini (national level) and the last shows a fairly significant increase of 1.9 percent.⁴⁶ Accordingly, a tentative judgment is that the tendency for increases in inequality continued more moderately in the 1990s, after some marked increases in the 1980s (Morley, 1995, 2001; Altimir, 1996, 2004; Bulmer-Thomas, 1996). Since the early 1980s, therefore, the increases in inequality have been rather widespread, and some have been large. Net decreases have been few, if any.

The reported changes in inequality since 1990 were not particularly concentrated either in the first or the latter part of the period; the important decrease, in Mexico, occurred between 2000 and 2002. Nor does there seem to be any obvious relationship between the observed distributional changes and increases in informality (though this did rise dramatically in Venezuela, where inequality rose moderately), declines in the relative income of informal sector workers (though this ratio fell sharply in Argentina, which registered the largest increase in inequality), or declines in the relative income of independent workers (though this was large in Costa Rica, where the increase in inequality was also large). These shifts in employment composition or in relative incomes may have played a role in countries like those cited. If they did, their impact varied across countries such that no very systematic associations emerged between changes in inequality and these labor-market indicators. It is also possible, of course, that because of weaknesses in the data on inequality, true relationships are hidden by data errors.

⁴⁴ As a result there are no very reliable series on distribution for any country. But the data are likely to reflect any major changes in real levels of inequality and, apart from the considerations mentioned above, there seem to be no obvious reasons to believe that the degree of bias will have changed much over time. The data used here reveal some patterns different from those in other sources but the more surprising ones—such as the declines observed for Colombia and Mexico—are also among the alternatives presented in the World Institute for Development Economics Research database.

⁴⁵ The ECLAC figures presented in table 4A.10 appear to refer to persons ranked by per capita household income. Hence, this is not the distribution among income earners.

⁴⁶ For countries without national data, those for the urban areas were used.

4.3 The Effects of Economic Integration: Main Points of Controversy

At some risk of oversimplification, it may be useful to distinguish points of (more or less) agreement and disagreement about how increasing economic integration has affected Latin America over the last few decades and which causal mechanisms have been at work. As closer integration and the progress of related reforms began selectively in the 1970s and broadly in the 1980s, these developments were naturally greeted with optimism by their proponents and with skepticism by their opponents. Views on both sides have subsequently evolved to take account of the ensuing outcomes. Proponents have refined and sometimes scaled back their expectations and claims; critics have generally intensified but also sometimes moderated their attacks.

The simplest initial view of many of the vocal proponents was that freer trade and other forms of liberalization would raise the growth rate of any country adopting this approach. Some also believed that distributional outcomes would be improved. Almost all probably believed that labor as a group would be better off, certainly as the beneficiary of faster growth and perhaps also of better distribution. As regards such social areas as education, health, and pensions, the parallel view was that the combination of faster growth and more efficient use of resources in these and other areas would benefit nearly everyone. Expenditure in such areas was seen as constrained by low GDP, inefficient because of excessive public sector domination, and often regressive because of the substantial role of politics in determining resource allocation. With the expected improvement on each front, it was easy to believe that all major groups of the population would be net winners from the liberalizing reforms.

At the outset, the critics' views were less clearly formed and less often articulated. Critics were also less inclined to use empirical evidence to attack the market solutions proposed, since those solutions were still on the drawing board and thus were not vulnerable to the criticism that they had been unsuccessful in practice. As is to be expected, on both sides of the fence there were more and less serious participants, reflecting in part their attachment to vested interests, their ideological preconceptions, and so on.

With the passage of time the debate has naturally focused much more on what has happened and why. As in the prereform phase, the trade and capital market reforms have received the most attention, though labor-market issues have come closer to center stage over the last decade or so. The

historical record has clarified some issues more than others. The trajectory of a country's growth rate is not open to much ambiguity. Highlights of the discussion about it include whether:

- The more appropriate reference point against which to judge the post-1990 growth of about 2.8 percent is the 1980s (slower), the previous 35 years (faster), or the East Asian record (faster still)
- Chile's impressive performance is the only meaningful test of the new model, since it is the only country to take full advantage of what the new model can offer
- The mediocre growth of the post-1990 period is not yet a true test of the new model because of the length of lags between policy change and its effects

In the areas of employment and distribution, debate continues about what the facts are and how to interpret them. There is disagreement about whether there has been a significant tendency toward increasing inequality and if that increase (if real) has coincided with or been the result of economic integration or of other factors such as ever-more-complicated and capital-intensive production techniques. The once-popular view that a considerable level of inequality might be a necessary condition for fast growth has lost favor over the years. No general argument to this effect receives much support from the evidence, although it could have some validity under certain circumstances.

With respect to social services, the disagreement as to the net balance is probably even greater, partly because of the complexity of the causal chains that might link economic integration with spending levels and effectiveness in these areas. On many issues such as the education and health system reforms and their effects, it is still too early to judge.

A reasonable overall assessment at this point would be that while the import-substituting industrialization (ISI) growth strategy employed by most Latin American countries from the end of the World War II until the market reforms began several decades later had its flaws, these were not nearly as grievous as its harsher critics have claimed. While outcomes varied from country to country, that strategy brought relatively rapid growth with constant (albeit high) inequality and hence a relatively rapid decline in poverty. It outperformed the then optimistic-sounding goal of 5 percent, set

in the early planning documents for most countries of the region, a rate that most planners probably did not expect to reach. Soon thereafter, however, much faster growth rates appeared in Asia: first in Japan and then in the East Asian tigers. Against the 8–10 percent growth rates of these countries at their peaks, the Latin American record did not look so good. Both defenses and criticisms of the ISI model come into clearer focus against those impressive performances. The fact that such growth rates can sometimes be achieved implies that even with a number of policy failures and/or a certain amount of bad luck, 5–6 percent growth is possible. Hence there is no reason to believe that Latin America's implementation of ISI was the best model possible. Perhaps LAC could have grown at 7–8 percent had policies been optimal during those decades, but the actual performance was still quite good by most historical standards.

Judged against the high standards of East Asia, LAC's postreform performance looks even worse, suggesting that the postreform strategy has been very far from optimal, that there has been an inordinate amount of bad luck, or that the model requires a long gestation period before it can realize its potential. The main message from the East Asian experiences is that LAC has probably always fallen substantially short of its potential economic performance. Probably the more useful contrasts are those between prereform and postreform performances in LAC itself.

The unsatisfactory outcomes following Latin America's greater integration into international markets and the accompanying policy reforms have generated a range of interpretations and policy recommendations. The most general type of difference is between (i) those who blame integration/the reforms for the poor outcomes and see little hope of revising them in a way that would lead to much better outcomes; (ii) those who believe the reforms have been well designed and that the unsatisfactory elements of subsequent performance are accidental coincidences—they thus expect the reforms eventually to bring the expected benefits after a longer lag than initially contemplated; and (iii) those who believe that the reforms can yield good benefits but only after serious adjustment, refinement, or even a reversal of some elements of the model. The liberalization of international capital flows is the aspect about which it is most often accepted that the reforms went too far, went too fast, or were out of sequence.

There is considerable convergence around the view that some markets, even if they can be a key to good resource allocation, will function well only

when carefully regulated.⁴⁷ An increasingly popular view is that now it is less a matter of cutting back on the size and scope of the state than of making it more effective. Stiglitz (2000) stresses a more activist role, a shift from the earlier Washington-style reforms that focused on the need for adjustment and for macroeconomic stability, and on “government failures” as the cause of inflation and allocative inefficiencies. The role of human capital, partly because its importance is highlighted by endogenous growth theories, has elicited more interest than before. There is greater recognition that education and health cannot be financed solely through market mechanisms (IDB, 1997). It is now more widely accepted that reform-based growth could widen wage differentials at first, even if, in the long run, it promotes higher wages for all (Edwards, 1995; Morley, 1995). A World Bank report on the role of institutions symbolizes this new direction (World Bank, 1998).

The emerging dominant view thus draws back from the overly optimistic expectations associated with the first wave of reforms—that they would be enough both to raise growth rates and to significantly reduce poverty.⁴⁸ The challenge of how to increase employment and raise wages, especially for unskilled labor, is now widely understood against a background acceptance that trade liberalization and greater integration into the world economy initially increase inequality by enhancing opportunities and increasing returns for skilled workers, and amid growing concern that they will not necessarily even promote growth.⁴⁹ Theories that envision possible multiple long-term equilibria and illustrate how high inequality may stall growth now receive more attention. ECLAC’s earlier neostructuralist analyses of Latin America long ago insisted that inequality constrains rapid growth (Sunkel and Zuleta, 1990), so there is now some convergence between old and new views in

⁴⁷ There remains a general tendency to leave market mechanisms center stage in discussions of how best to achieve goals like employment creation and poverty reduction. See, for example, Birdsall and others (1997) on the contrast between the countries of East Asia and those of Latin America. The authors argue that the former have relied on increasing opportunities as the route to poverty alleviation whereas the latter have focused more on transfers. For useful general statements falling within the category of “revised consensus thinking,” see Birdsall and de la Torre (2001) and Burki and Perry (1997).

⁴⁸ “If speculation about converging incomes and living standards is to cede to a realistic policy agenda, it is necessary to have a firm grasp of what drives economic growth in a market economy” (UNCTAD, 1997).

⁴⁹ “Among the asymmetries of globalization is the fact that liberalization of the world economy has proceeded so far in a lopsided way that it tends to prejudice the growth prospects of developing countries by discriminating against areas in which they can achieve comparative advantage” (UNCTAD, 1997).

this area. In short, the discussion is increasingly nuanced and no longer so rife with exaggerated positive assessments of the role of markets. This shift reflects the greater availability of data and the associated trend toward giving greater prominence to the views of more careful analysts. Whereas a quarter of a century ago the wide differences of opinions on the impact of economic integration often reflected extreme, ideological, and ultimately indefensible positions, the somewhat less wide discrepancies are now more likely to reflect the real difficulties of interpreting the empirical record.

The initial optimism about market-oriented reforms was especially ill-founded with respect to financial repression and the benefits of freeing financial markets and moving toward international financial integration (Díaz-Alejandro, 1985). It tended to assume an institutional framework that did not exist. That naiveté has a current parallel in at least two areas. First, in some policy domains it is not clear how well the regulation needed to make markets work well can be effected (for example, control of monopoly/oligopoly power). If the answer is “badly,” then serious thought must be given to second-best options. Second, there has been a tendency to accept that a certain type of macroeconomic management is a necessary condition for strong growth, a view encapsulated in the expression “getting the basics right.” There may well be some “basics” that have to be right, but exactly what they are and how they vary among countries is unclear. The view that very low rates of inflation are “good” is as unproven as the earlier view that eliminating financial repression would resolve the problems of the financial sector.⁵⁰ This view has somehow become generally accepted without being subjected to much serious analysis.

As regards the causal processes connecting economic integration, inequality, and poverty, disagreement is the norm rather than the exception. This is not for lack of extensive study of the correlates of inequality, in which the most striking aspect is the usually wide income variance associated with differences in education levels. Other correlates, such as the region of the country in which people live, whether they work in the formal or the informal sector, gender, and (in the relatively few attempts made to measure it) ability, all have much less explanatory power than the level of education. The role of capital incomes in overall inequality is less understood than that

⁵⁰ See the discussion below on how very low inflation can impede effective labor market functioning.

of labor incomes and how they are determined, since the former are poorly measured—with almost no exceptions in the developing world, let alone in Latin America. Hence it is possible that differences in nonhuman capital explain much of the income variance, but the standard analysis does not reveal this because of the lack of complete and accurate coverage of those forms of capital income. Unfortunately, identifying the causes of changing levels of inequality is a much greater methodological challenge than identifying the correlates of inequality at a given time. Thus far, the modest efforts made to address the matter have largely been frustrated.

4.4 Determining the Impact of Increased Integration and Economic Reform

For Latin America today, it is an interesting challenge to explain the deceleration of growth between the heyday of the ISI strategy (when it averaged 5.5 percent a year for the region) and the recent postcrisis period (average of about 2.8 percent for the period 1990–2004). A modest part of this difference is accounted for by the slower growth rate of the region's labor force: about 2.6 percent a year since 1990, against about 3.5 percent a year over the earlier period.⁵¹ The investment rate has been substantially lower, which explains a more significant part of the difference. The ratio of marginal gross output to gross investment has also been lower, though this is hard to interpret because it is less clear whether the conceptually more relevant marginal net output to net investment ratio is also lower (since it is harder to estimate). Investment and technological change are recognized as the key variables in explaining growth rates, but their determinants are not well understood. It is more difficult to predict the impact of a policy change like liberalization on investment or technological change than on the composition of output between tradables and nontradables—the focus of static international trade theory. Most calculations based on that static theory have predicted relatively small efficiency gains in GDP from the removal of price distortions such as tariffs on imports. When studies predict large effects they usually

⁵¹ Although rapid population and labor force growth presumably leads to slower growth of per capita income, it does lead to somewhat faster growth of total income.

involve some assumption about the impact of policy change on investment or technical change. But it is clearly risky to assume that a little-understood variable like investment, one that depends a great deal on what Keynes called “animal spirits” (the gut feelings of businesspeople), will respond positively to a particular reform. It may be that the ISI framework provided significantly greater perceived security of returns to the investor, as Hirschman (1965) predicted it would, than a more open market typically does. Another obvious factor in Latin America’s slower growth has been the impact of the financial crises that have plagued the liberalization period.

Despite the slowdown in growth, defenders of the reforms could and do argue that growth has been better (or will eventually be better) under the new policies than it would have been over the same period under the old ones, for several reasons. These include the following:

- The ISI model’s capacity to produce high growth was coming to an “inevitable dead end”⁵² in the 1970s, which contributed to the region’s rising indebtedness during that decade and to the ensuing debt crisis.⁵³
- The period of ISI growth was more favorable to fast growth for exogenous reasons, such as high commodities prices, than the period since 1990. There have been two recessions in North America since 1990, and these have helped lower the average growth in Latin America.
- The combined legacy of ISI and the debt crisis has hampered growth under the new model and kept it below its potential.
- Like any other model, the newly adopted neoliberal one has been undergoing its own “learning by doing” phase and is not yet performing at full potential. For it to do so, the initial flaws must be rectified—including elements of the ISI legacy. The mistakes surrounding the freeing of international capital flows to and from developing countries have constituted one major flaw.

⁵² This phrase appears in then-President Wolfensohn’s introduction to a report put out by the World Bank (1995).

⁵³ The “running out” argument has some plausibility, but not a great deal, since countries like Brazil and Colombia were already taking the obvious step of combining domestic market protection with encouragement of exports well before the debt crisis hit. In other words, they were starting to follow the East Asian recipe in this regard. A more serious threat than the “inevitable” dead end due to purely economic factors is the danger of countries’ pursuing a narrow import-substituting industrialization policy for too long because of policy error and/or vested interest considerations. In other words, sometimes a bad end may indeed have been inevitable, but for purely political reasons rather than economic ones.

The latter two arguments are probably the most plausible. All four might possibly have some validity, but the startling fact in any comparison of growth between the ISI period and the neoliberal period (granted that there is ambiguity as to exactly how each should be defined) is the large growth differential (almost 2:1) in favor of the former.⁵⁴ To argue that the new model is substantially more conducive to growth than the old one—a reasonable definition of “substantial” being a growth advantage of at least 1 percent a year—one must believe that the above-cited arguments account for an enormous differential of over 3.5 percent a year. That is the difference between actual growth of 2.8 percent and the 6.5 percent that might be termed “significantly superior” to the ISI growth record.

The reform optimists who believe that greater openness speeds growth point to the experience of Chile—and there is no doubt that Chile’s performance has been impressive since its crash in the early 1980s, though it is also true that a huge capital inflow (nearly 9 percent of GDP in the period 1979–85) must have played a role (Berry, 2008c). It has also been noted that recent growth for Latin America as a whole has been strong, at about 5 percent in 2004–5, which might indicate that the corner has been turned. Some point out that the region also did well briefly in the mid-1990s, before performance was weakened by a series of financial crises. Nonetheless, achieving growth of 5 percent in a few good years is not equivalent to attaining that rate as an average over 30 years.

Some supporters of liberalization evinced optimism about its effects on income distribution. This too has been seriously in error, judging by the frequency of increases in inequality since the policy reforms were instituted. Though this pattern is by no means universal, as noted above it has been frequent enough to produce a considerable rise in the region’s average in-country inequality levels (see Berry and Serieux, 2007). The gap between hoped-for declines in inequality and actual increases has probably been greatest in Latin America, where inequality has historically been high. In this case, one source of erroneous predictions was the implicit assumption that Latin America’s wages were low enough to allow it to export principally labor-intensive goods. In fact, various Asian and African countries claim the “low wage” title, and it is they (mainly the Asians) that have won international markets in highly

⁵⁴ In terms of per capita output growth, the differential is even greater at about 3:1.

labor-intensive products. Thus the expectation that an increase in trade would lead to an increase in the real wage of unskilled labor did not apply in Latin America, but rather in countries such as Vietnam, China, and Bangladesh. Discussions about distribution also placed less emphasis than they should have on the downward pressure that freer trade exerts on the price of machinery in developing countries; cheaper machinery discourages the use of labor. And those discussions usually disregarded the fact that because larger firms tend to be better placed to engage in international trade (especially long-distance trade with developed countries) and are typically more capital-intensive than smaller firms, a bigger role for them under circumstances of freer trade could increase income inequality.

An interesting aspect of increases in inequality where they have occurred, and one that is still unexplained, is that the gains in income share often appear to have been limited to a small (sometimes very small) group at the top of the income hierarchy, mainly the top 1 percent or so of earners and seldom more than the top 5 percent. It might be hypothesized that economic openness would have this effect by increasing the potential scope of operation for those firms already operating at a large scale, selling a very scarce product or skill, or very well connected to international actors. But this issue remains to be analyzed in detail.⁵⁵

If it is true, as argued by Cornia and Court (2001), that “liberalization of the domestic and international financial system has caused an increase in income inequality much greater than that caused by other policy changes such as trade and labor market liberalization and privatization,” then this component of the reforms may be equally culpable on the income distribution side as it appears to have been on the growth side.

The Literature on Trade and Growth: Improving, but Still Not Dependable

Many of the earlier studies that sought to establish causal links between international trade and growth were understandably vulnerable to data and methodological weaknesses that, at least partially, may now be overcome.

⁵⁵ It must be noted that any conclusions relating to the very highest income earners are especially open to problems of data quality.

Some were careless. Much play was given to the fact that export growth tends to be positively correlated with output (GDP) growth, but many studies were unconcerned with distinguishing the basic proposition—that more export activities *produced* growth—from the competing possibilities that more exports and more growth were the *joint result* of something else, such as the discovery of a new and exportable natural resource, or that faster growth tended to lead to more exports. This weakness has been increasingly rectified over time. In terms of the economic variables involved, probably the two greatest remaining weaknesses in the body of research relating international trade to growth—and perhaps to inequality (though this is less clear)—are (i) the failure to recognize more systematically the pivotal role of the real exchange rate as a determinant of trade, growth, labor allocation, and other outcome variables and (ii) the failure to understand adequately how economic integration affects the amount and productivity of investment. In addition, however, some of the assumptions necessarily built into cross-country econometric techniques are questionable, perhaps especially those related to lags between cause and effect; it is quite possible that these vary considerably from country to country and period to period. The frequent sloppiness of the discussion of trade and growth no doubt owed much to the importance of the policy issues associated with it and the vested interests involved. As Stallings (2000) notes, a principle frequently violated in the prereform discourse was the need to obtain the necessary information and engage in the necessary analysis before making irreversible policy decisions. Hence it is not surprising that “many of the predictions turned out to be erroneous.”

As might be expected in a literature that initially suffered from limited methodological sophistication,⁵⁶ early “truths” have later become “possibilities” or “probabilities,” as the case may be. In a recent careful review and critique of the economic literature on the relationship between trade and economic growth, Hallak and Levinsohn (2004) conclude that “once earlier methodological problems such as endogeneity and omitted variables are addressed, there is no further evidence of a significant connection between openness and growth.” Earlier, Rodríguez and Rodrik (2001) had made a similar judgment.

⁵⁶ While even the more misleading early studies were not generally wrong, in the sense of drawing one set of conclusions when a different set was jumping out of the data, they were wrong in the sense of failing to identify and flag the uncertainties due to failure to meet econometric standards satisfactorily (often because the data made it very difficult or impossible to do so).

While this still appears to be a minority view, even among the reasonably serious researchers, it is clear that there is much more ambiguity than first appeared to be the case, even when the analysis focuses on the too-general question, “Does more trade, on average, contribute to more growth?”

From the broader methodological perspective of the questions the research is trying to address, perhaps the greatest specific weakness of the trade-growth studies has been the failure to design tests to distinguish between the relative validity of (i) the proposition that greater freedom to trade is optimal under all circumstances and (ii) the plausible competing view that though a lot of trade is beneficial under most (perhaps all) circumstances, there are particular situations in which free trade is not best. If one accepts, for example, that the strongest argument for some protection is related to infant-industry learning, then one must perform a test that identifies cases in which such protection was undertaken appropriately and that compares the outcomes to those of otherwise comparable situations in which such protection was not provided (or provided to a different degree).⁵⁷ A related and methodologically more tractable question is whether the payoff of more trade diminishes as a country’s trading ratio rises. It would be plausible to expect this outcome, because if there is any rationality in a country’s trade policy it will tend to ensure that the most valuable trade is permitted even if other trading possibilities are curtailed by protection of domestic producers. Few, if any, studies include a variable to serve as a proxy for the gap between the actual trade/GDP ratio and the (estimated) value of that ratio under free trade.

Another error in the category of “asking the wrong question” is made by some of the studies that focus on the mechanisms whereby freer trade or capital flows could affect growth but do so inappropriately. Many of the analyses that have found reforms to be associated with rising productivity are guilty here. For example, Winters and others (2004)—having noted some of the ambiguities in the statistical relationship between trade and growth—point out that “by universal agreement, improved productivity is necessary for sustained economic growth and development.” But this statement is only unequivocally true when the productivity increase in question refers to the

⁵⁷ Such a test must allow for the fact that the protection in question would be expected to lower national income in the short run but raise it later by a more than offsetting amount, and over a period that would vary with the rate of learning-by-doing in the industry in question. It is implausible that any cross-section analysis could be so finely tuned as to identify beneficial protection of this sort.

country's full labor force. Usually, however, the cited data—for example, on TFP growth—refer at most to the modern or formal sector, and often only to the modern manufacturing sector. Much evidence for Latin America suggests that trade liberalization raises productivity in certain segments of the economy but not in the economy as a whole.⁵⁸ Thus productivity growth in modern manufacturing may be a poor proxy for economy-wide TFP growth, and will certainly be so if there is reason to believe that productivity gaps are widening across groups of firms. The trade literature has not adequately taken account of the fact that technologies and productivities vary enormously within developing countries, and thus it is always dangerous to look at what is happening in potentially atypical segments.

One study that tries hard to recognize heterogeneity across firms is that by ECLAC; its conclusion that the reforms brought a small positive impact on growth (Stallings and Peres, 2000) is thus of special interest. This study also avoids the common weakness, deliberate or not, of comparing postreform periods (which are also postcrisis) with the poor growth performance of the crisis years, since its base or reference period for each country covers the years from 1950 up to the country's "crisis period" (Stallings and Peres, 2000). Its results on the growth impact of the reforms, however, should be viewed with caution for two other reasons. First, as the authors point out, there was a tendency for countries doing badly before the reforms to undertake them and to benefit from them. The payoff to the reforms may thus have been less general than the regression results seem to imply—for example, they may have been much more productive in some countries than others. Second, the countries studied ranged from very small (Costa Rica and Jamaica) to very large (Mexico and Brazil). When observations are not weighted by country size, what happens in small countries can substantially determine such cross-country regression results. Here, the "high-growth" countries in the reform period are Argentina (then amid its unsustainable growth burst), Bolivia, Chile, and Peru, while the "low-growth" countries are Brazil, Colombia, Costa Rica, Jamaica, and Mexico—that is, the two biggest countries (and three of the four biggest). The apparent anomaly that the regression results credit the reforms with growth

⁵⁸ If a productivity-increasing effect were present for the economy as a whole, it would show up in faster GDP growth. Winters and others (2004) give added attention to the observed association between trade increases and TFP increases in part because, as they note, the statistical association between trade and GDP growth is often weak or ambiguous.

benefits when overall regional growth was so much lower in the postreform period probably has its roots in the fact that the region's growth is dominated very heavily by just two of the biggest countries (Brazil and Mexico), while small countries such as Costa Rica and Jamaica have essentially no weight at all. It is thus important that future studies undertake such regression with the observations weighted as well as unweighted by country size.⁵⁹ The anomaly just cited is of interest not only because it highlights complexities in how cross-section regressions designed to identify the average impact of reforms should be interpreted, but also the fact that such impacts may vary greatly across countries. A simple possible interpretation is that ISI worked best in larger countries (again, especially Brazil and Mexico) and worst in smaller countries. This conclusion may be deemed almost "common sense," since it is known that trade matters more to smaller countries on average and that protection can most easily backfire there.

Proponents of trade liberalization argue persuasively that for its full benefits to be felt, complementary policies must be implemented along with it (Winters and others, 2004). Critics sometimes say that implementation of such policies would only make things worse. For some proposed complementary policies (better governance, say), it can be an insurmountable methodological challenge to test their joint impact (with trade reform) against the historical record in cross-country analyses. But a key complementary policy—good exchange-rate management—can certainly be brought into the analysis, and should be included in any case since it is an important determinant of economic performance.⁶⁰ Country case studies have a better chance of shedding light on these and many other issues, in spite of their own limitation, related to the challenging task of putting the results of many such studies

⁵⁹ An updated version of the study would probably also find different results for the capital account liberalization index (here credited with a positive growth impact), since the late 1990s crises associated with such liberalization had not yet occurred in the period covered by this study.

⁶⁰ A classic case where failure (or inability, as the case may be) to prevent a currency appreciation meant that freer trade did permanent damage to some sectors that might be presumed to have long-run competitiveness was Mexico in the early 1990s, when foreign capital arrived in large amounts. Such damage should be attributed to the combination of low protection and an appreciated exchange rate. Any policy, whether free trade or ISI protectionism, will by definition work best when optimally complemented by other policies. To be as helpful as possible, economic analysis must take account of how any given policy change is likely to affect the appropriate and the actual implementation of other policies. In a country in which capital flows can no longer be controlled, trade policy changes must thus be analyzed under that realistic assumption. Where exchange rate policy has potential bite, its predicted and suggested management should be fed into the analysis of any other policy change.

together into a usable and interpretable set of conclusions. Evaluating the methodologically more heterogeneous literature that looks at trade policy in specific countries' case histories is probably just as hard as evaluating the cross-country work. It is clear that there are many careless, incomplete, ideology-led, or otherwise unpersuasive case studies, as well as some careful and persuasive ones. Probably the main message of these studies is that, historically, countries could perform either well or not so well under either free trade or high protection. There have been cases where trade liberalization was very successful, at least from a growth viewpoint (Chile, Ireland) and others where success came with relatively high levels of protection (South Korea, Taiwan, Brazil, and Mexico).

Does the Manufacturing Sector Play a Special Role in Growth, Employment, and Income Distribution?

Economists and policymakers have usually paid special attention to the role of manufacturing on the grounds that its importance is somehow greater than its share of output or employment. Accordingly, much consideration has been given to how this sector responds to liberalization. During the last quarter century in Latin America, there has been a net decline in manufacturing's share of employment (and hence a more marked decline in its share of non-agricultural employment). Is this a serious cause for concern, in the sense that it might have contributed to the loss of growth dynamism and/or the unsatisfactory labor-market outcomes? The more or less obvious reasons to believe so include not only the widespread presumption that manufacturing activity (or at least some part of it) promotes growth more than other activities do, but also the following:

- The belief that the employment and income distribution problems of many industrial countries in recent decades have been partly the result of the relative decline in manufacturing (from a peak of 26.8 percent of employment in 1970 to 17.3 percent in 1998; see Palma, 2005), with an ensuing loss of positive spillover effects and a pattern in which generally well-paid manufacturing jobs are replaced by a combination of very well-paid skilled jobs (those who design and manage the robots that replace human workers, for example) and low-paying service sector jobs (at McDonald's, for example)

- The fact that growth takeoffs in both China and India (more generally, South Asia) in the 1980s were associated with significant increases in the manufacturing share of employment in those countries and their growing share of world manufacturing employment (which seems to have been relatively stable at 13.5–14.5 percent since at least 1960)
- The parallels between the loss of manufacturing employment as a consequence of classic cases of Dutch Disease (especially the Netherlands itself) and what has happened in many Latin American countries recently—albeit mainly as a result of the policy shift toward liberalization in the latter case

The nature of the often-hypothesized benefits of industrialization, however, complicates their statistical confirmation, especially as regards employment.

Generally, across the region and significantly in degree, the impact of the liberalization of trade and capital markets on output, trade, and employment in Latin America's manufacturing sector seems to have varied by country and subregion. With regard to employment, in the Southern Cone countries, including Brazil, manufacturing had a relatively high share of employment in 1960 at 17.4 percent—well above the world average but far below the 26.5 percent for the industrial countries (Palma, 2005: 4). This share changed only modestly over the next three decades, and then plummeted from 16.6 percent to 11.8 percent between 1990 and 1998. During this period, both Chile and Argentina experienced growth booms, and although Brazil did not, its performance was at least middling. The issue raised most clearly by Chile's experience⁶¹ is whether this sort of natural-resource-based growth boom can be a building block toward long-run successful growth and employment creation when it is associated with a small or even shrinking level of manufacturing employment. If the answer is yes for a country like Chile, which has a high endowment of natural resources per person, can this result be extrapolated to countries like Brazil, Mexico, and Colombia? And will continued growth in Chile eventually involve or require a resurgence of manufacturing employment?

The evolution of manufacturing employment has been different outside the Southern Cone, taking the remainder of the region as a whole. Between 1960 and 1980, manufacturing's share of total employment rose substantially from about 13.5 percent to about 16.8 percent, then fluctuated a little and

⁶¹ Argentina's boom is less interesting since it followed such a long period of stagnation and itself came to an abrupt and crashing end.

settled at about 16.6 percent in 1998. This pattern owes a good deal to the rapid growth of maquiladora employment in Mexico and Central America, growth that has offset the decline of traditional manufacturing employment. But the figures have also held up relatively well in the Andean Community countries, where manufacturing's share of employment in 1998 was near or above developing-country averages, except in Venezuela (Palma, 2005). The traditional theories of the special benefits of manufacturing activities do not suggest long-run positive spillovers from maquiladora activities, given their very modest linkages to the rest of the economy, though these do make a strong short-run contribution to employment. And Palma notes that although the maquiladora effect in Mexico and Central America has led to a faster than predicted increase in manufacturing's share of employment (except perhaps in Mexico), it has not been associated with the sort of income growth that occurred in East and Southeast Asia. Recently, Mexico has been losing a good deal of this activity to China, as might be predicted given its reliance on cheap labor and its footloose character.

A predictable effect of liberalization on manufacturing, especially in the nonmaquiladora countries, is to rapidly increase labor productivity, particularly in the export-oriented component of manufacturing and above all when it is undertaken by multinationals. In that situation manufacturing output grows much more than does manufacturing employment, and such a pattern can be seen as a replay of the industrial-country experience since 1960. In that case there was not much difference in output growth between manufacturing and services until the 1990s (Palma, 2005), but throughout there was a large productivity growth gap in favor of manufacturing and hence a correspondingly large gap in employment growth against manufacturing. If this scenario has been unfolding more recently in parts or all of Latin America, albeit sometimes disguised by the growth of maquiladora employment, does it portend or, in some cases, explain similar employment and distribution outcomes as those seen in the industrial countries? In the period 1990–2003, when GDP for the region as a whole grew at about 2.5 percent (ECLAC, 2004b), manufacturing output rose by 1.9 percent (and thus fell from 20.1 percent of GDP in 1990 to 18.9 percent in 1993), while services grew at an average of 2.5 percent (agriculture outgrew both at 2.7 percent). These data suggest some widening of the labor productivity gap in favor of manufacturing over services (the labor productivity of agriculture was clearly catching up during this period), but not a dramatic one. In addition to the

maquiladoras, another possible reason why the outcome differed from that in the industrial countries is that small-scale, low-productivity manufacturing enterprises may be harder to squeeze out in Latin America because the employment alternatives are not good. Their continued presence slows the labor productivity growth of manufacturing as a whole.

Understanding the implications of these trends in manufacturing activities may be central to drawing a balance between the benefits and costs of liberalization. Trade protection has been designed mostly to foster more modern manufacturing and thereby help a country move up the value chain of activities. Palma (2005) sees the Latin American case as one of policy-induced Dutch Disease. At the other end of the spectrum are the experiences of Finland, Sweden, and Malaysia, and to a lesser extent Thailand, Indonesia, and the Philippines, which demonstrate that there is no necessary “curse of natural resources” (Palma, 2005). In his judgment, these countries have used their policy space to remain strong in industry. Palma’s highly provocative analysis deserves to be deepened, so as to permit a better understanding of the meaning and implications of recent trends in Latin America.

Determining the Effects of Economic Integration on Inequality, Poverty, and Other Labor-Market Outcomes

The distributional effects of economic integration could make themselves felt through a wide variety of causal mechanisms, but most would work through the labor-market variables: employment, unemployment and underemployment, and wage rates. Because there are often trade-offs between desirable outcomes (for example, high levels of employment versus high wages), not one of these indicators by itself—nor sometimes all of them together—are guaranteed to give a reliably good picture of labor-market outcomes. Thus the best overall gauge of those outcomes is likely to be the distribution of labor incomes, which in most countries is rather closely approximated by the distribution of incomes reported in the household surveys that provide the data with which analysts have to work. This section therefore turns to a discussion of the relationship between the increasing economic openness of Latin American countries and their levels of inequality. Subsequently, it considers the evidence on links between openness and wages, unemployment, and other variables in the causal chain, and between openness as a causal factor and the distribution of labor incomes as a final outcome.

To put the discussion in context, it should be noted that, judging by its probable impact on inequality, economic integration is not one of the major determinants of poor labor-market outcomes in Latin America. As measured by the reported Gini coefficients of income distribution, there is a wide gap in inequality between the most egalitarian market economies (Taiwan, a few years ago) at about 0.3 and the least egalitarian (for example, Brazil and South Africa) at about 0.6. A variety of factors account for this gap of 0.30 points between the best and the worst, one of the most prominent being a large difference in the variance of educational level (low in countries like Taiwan, high in countries like Brazil). As most studies of inequality point out (see, for example, de Ferranti and others, 2004: 1), many of those factors are deeply rooted in existing economic and institutional structures that make rapid improvement difficult and rare. The average inequality-increasing impact of the liberalizing reforms in Latin American countries probably lies between 0.01 and 0.05 points of the Gini coefficient, perhaps rising to 0.08 or so in extreme cases (possibly Chile).⁶² Such an increase thus probably amounts to between one-thirtieth and one-sixth of the gap between the egalitarian and inegalitarian ends of the observed spectrum. To put this further into perspective, the largest increase in the reported Gini coefficient of a market economy over a short period (say, a decade) is probably the approximately 0.1 increase in the United Kingdom and New Zealand. There have been much larger increases in Russia and China during the transition from socialism to a more market-based economy (Milanovic, 1998; Benjamin and others, 2008).

The observed increases in Latin America during the reform process are relatively small when placed against the total gap in inequality across countries, but they loom large in comparison to previously observed changes in the region and to what might be called the “realistic wiggle room” for this variable. Since income distribution data began to be collected fairly systematically in Latin American countries in the 1960s and 1970s, there have been no previous episodes in which inequality rose by as much as it seems to have done in some countries during the reform process. It is also

⁶² For there to be many examples in which the Gini coefficient increased by more than 0.05 because of economic integration, it would have to be the case that the great bulk of true inequality increases were due to this cause and that true inequality increased more than indicated by the standard measures. The latter condition would be most likely to hold if, because of their failure to capture much of the capital income in these economies, the reported figures understate the true ones by more after the integration than before. While somewhat plausible, this hypothesis is essentially untested.

true that what appears to be a modest numerical increase in the Gini coefficient may have a much greater social meaning, depending on how and how much people focus on their incomes relative to those of others as a source of dissatisfaction.

Though there is little serious argument to the effect that openness has improved equality, there are interesting views to the effect that the observed worsening in a number of countries came from other sources, particularly from labor-displacing technological change not attributable to the reforms. Although several studies have made useful contributions to the analysis of the distributional impacts of the reforms, nothing approaching firm conclusions can yet be drawn because of the complexity of the issue.⁶³

Stallings and Peres (2000) summarize the results of a large and generally good research effort carried out by a team of ECLAC researchers on the impact of the reforms on growth, employment, and distribution in Latin America. They state that “the econometric evidence suggests that the reforms have had a surprisingly small positive impact on growth and investment together with a small negative impact on employment and income distribution” (Stallings and Peres, 2000).

Only by moving to the country, sectoral, and microeconomic levels do they find evidence of stronger effects:

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. The result has been specialization and polarization, which implies both opportunities and challenges. . . . Trade liberalization and privatization were instrumental in fostering market restructuring, which led to the entry of new actors and to new

⁶³ Winters and others (2004) begin their generally useful review of the relationship between trade liberalization and poverty by noting (p. 72) that “if trade liberalization and poverty were both easily measured, and if there were many historical instances in which liberalization could be identified as the main economic shock, it might be easy to derive simple empirical regularities between the two. Unfortunately these conditions do not hold, so there is relatively little direct evidence on this question.” They conclude (p. 108) rather cautiously that “with care, trade liberalization can be an important component of a pro-poor development strategy.” But their review, in spite of its many merits, fails to recognize that the statistical tests performed so far do not shed any significant light on the key question, noted above, of whether protection can be beneficial when well designed and executed.

investment, particularly of foreign origin. Stronger competition from imports and from new actors in the domestic market led to widespread modernization, particularly in sectors undergoing rapid technological change, such as telecommunications. . . . Large firms, especially subsidiaries of transnational corporations, were the leaders in both investment and the incorporation of new technologies. Small domestic firms presented a very heterogeneous performance, but continued to produce mainly for the domestic markets. Consequently, they performed better when macroeconomic conditions were favorable.

The study concludes that the reforms had favorable effects in several areas, but they were not sufficient to “foster dynamic, stable economic growth in the region. Moreover, the region’s problems in the areas of unemployment and inequality will not be resolved unless the reforms are complemented with policies to foster competitiveness, job creation, and a better income distribution.”

On the basis of Morley’s (2001) contribution to the project, Stallings and Peres conclude that the effect of the reforms on distribution was indeed negative but less dramatic than often believed. Other multicountry studies of the impact of globalization and liberalization on inequality in Latin America include IDB (1997), Behrman and others (2000), Berry (1998), and Bulmer-Thomas (1996). The IDB study used an econometric analysis similar to that of Morley (2001) for ECLAC but achieved different results, concluding that the most severe deterioration in income distribution took place in the 1980s, that there were no further increases in the 1990s, and that the reforms—including the trade reforms—actually made distribution better than it would have been otherwise. It also argued that “while structural reforms have greatly facilitated growth and benefited lower income groups, these reforms have been operating against the countervailing effects of very slow and unequally distributed progress in education.” Given that the methodology was similar to that used by Morley (2001), that Morley worked from the reform indices developed by the IDB but improved them, and that he undertook a more thorough econometric analysis with longer data series, it is reasonable to assume that Morley’s results are the more reliable of the two.⁶⁴ It is unlikely that the

⁶⁴ Also, as noted earlier, the IDB (1997) argument that lagging growth of education was a key contributor to the poor outcomes is not well documented at present.

reforms may have had a positive effect on distribution. ECLAC's conclusion that the reforms had only a small positive impact on growth is more likely than the IDB judgment that there was a substantial positive impact, but it too is probably unduly optimistic.

Behrman and others (2000) use the reform indices referred to above but focus on wage differentials across earners rather than the overall level of inequality among families. They report that the overall reform index was significantly related to increases in wage inequality, though the intensity of this effect declined over time.⁶⁵ The strongest contributors to the disequalizing effect were domestic financial reform, capital account liberalization, and tax reform. Trade reform had no discernable effect. Morley (2001) concurs on tax reform, but finds the impact of trade reform to be regressive, that of capital account opening to be progressive, and those of financial reforms and privatization to be unstable across regressions, leading him to withhold judgment on them. He complements the regressions by relating levels of independent variables to levels of inequality, with an attempt to explain changes in inequality, and again finds the impact of the overall reform index to be regressive. The differences between these two studies, and the sensitivity to specification of some indices' coefficients, indicate the considerable and hardly surprising fragility of the results of such exercises. It is somewhat reassuring that both studies found the effect of the overall reform package to be in the same direction (regressive), even though they are looking at different types of inequality.

Berry and associates undertook a series of country case studies (reported in Berry, 1998), using somewhat differing methodologies according to the country but not employing the cross-country econometric analysis of Morley and the IDB. Their conclusion that the reforms, mainly trade reform and the associated opening up, may have been a factor in worsening inequality arose from the coincidence of timing in a number of the countries (Argentina, Chile, Colombia, the Dominican Republic, Ecuador, Mexico, and Uruguay) between policy change and worsening inequality.⁶⁶ The set of countries analyzed was not identical to that used by ECLAC. Some of the distribution series used in the work on a given country—Colombia, for example—also differed between

⁶⁵ A similar result emerges in the study by Taylor (2000), based on a sample of countries, most of which are in Latin America.

⁶⁶ The set of studies reported by Bulmer-Thomas (1996) also points in this direction.

the two studies. The differing conclusions could reflect either of these elements, among many other possibilities.

Without detailed examination and comparison, it is not possible to determine which of the existing studies, if any of them, gets close to the facts of the matter. A prudent judgment might be that the truth probably lies between the Morley results and a negative reading of the Berry (1998) results—that is, an interpretation that is toward the pessimistic end of the range suggested by the latter study and that basically assigns all or nearly all of the distributional deterioration that coincided with the reforms to the reforms themselves, particularly reforms in the areas of trade and capital flows. In the latter case, the reforms could have accounted for increases in the Gini coefficient of up to 5 percentage points in several countries but not in all, and thus the average impact would be perhaps half that much. Morley's results suggest a much smaller effect,⁶⁷ and one that is not always statistically significant.⁶⁸ In all cases it is likely that most of the measured increases in inequality reflect what is happening to the distribution of labor incomes, since capital incomes are not at all well reported. Hence changes in the level and structure of labor demand are probably behind the reported cases of worsening distribution.⁶⁹

It is to be expected that the employment/distributional impacts of economic integration would vary considerably by country, a fact that can only be imperfectly dealt with in cross-country econometric studies. Morley takes some steps to address this problem in his analysis. Various case studies have also produced useful results. In one, Harrison and Hanson (1999) assess the extent to which the rise in the ratio of skilled to unskilled wages in Mexico during the 1980s was associated with the 1985 trade reform. They report some

⁶⁷ This is true whether one considers trade reform alone or the whole reform package.

⁶⁸ Differences in the conclusions of the studies by Morley and by Berry and associates are, to a minor degree, due to differences in the income distribution data they use. The two studies concur that the initial adoption of the reform package coincided with a big, one-time upward shift in inequality in Argentina, Chile, and Mexico (Morley, 2001), and that there was no significant shift in Brazil or Costa Rica and an improvement in Peru. Morley argues that there was no increase at this time in Colombia, while Berry and Tenjo (1998) conclude that there was. Clearly it will take considerably more work to sort out the remaining puzzles in the record within Latin America, and that work will have to include high-quality analyses of individual countries.

⁶⁹ The continuing lack of robustness of results on the relationship between trade and inequality for the developing world as a whole is exemplified by the recent finding by Milanovic and Squire (2005) that openness hurts poorer deciles in low-income countries when the variables are defined by levels, but not when they are defined by changes.

evidence of its consistency with the Stolper-Samuelson theorem, in as much as protection was skewed toward low-skilled sectors before the reform and tariffs fell further in sectors with a higher share of unskilled workers. They also present evidence from plant-level regressions suggesting that “foreign direct investment, export orientation, and technological change also played an important role in the observed increase in inequality.” Beyer and others (1999) report that the fall in the price of labor-intensive goods in Chile helps explain the increase in wage inequality during the last two decades, though they do not examine the mechanisms that might underlie that link. A number of studies like these have identified or suggested negative distributional impacts of trade reform, but most find surprisingly small effects on employment at the firm level. They lend tentative support to the proposition that the overall distributional effects of further integration may be small. But they too struggle to deal effectively with the nature of lags, and hence leave open the possibility that the longer-term effects may exceed those of the short term.

Functional income distribution: capital income and the overall wage level. The empirical analyses cited above use either household distribution data, relating mainly to labor incomes, or data on wage differentials between more and less skilled workers. They do not (except implicitly) focus on the overall wage level or the functional distribution of income between labor and capital. No study, multicountry or otherwise, has dealt effectively with the problem of the underreporting of capital income. There is a serious possibility, therefore, that the impact of the reforms on true inequality might have been substantially more negative than any study has found. This is especially true in light of the findings reported by Cornia and Court (2001) on the role of interest income in observed increases in inequality in several countries, as studied in the project of the World Institute for Development Economics Research (WIDER). In that case, the pessimistic end of the range of possible effects of integration on the Gini coefficient might reach as far as an average of five percentage points or so.

In the absence of reliable data on capital incomes, a stronger sense of the behavior of the functional distribution of income can be deduced from data on the overall wage level and the wages of specific occupational categories. In his recent breakthrough analysis for developing countries, using recalibrated ILO wage data by occupation for many countries (not only those of Latin America), Rama (2003) finds that openness—measured

either by trade flows or trade-liberalization policies—lowers the average monthly wages of males. A 20 percent increase in the ratio of trade to GDP is associated with an initial wage decline of 5–6 percent, but after a fairly short lag of about four years the effect on wages becomes positive. A plausible interpretation would be that increased openness has led to greater growth that pulls wages up again. The results are robust to a reasonable set of control variables and lags, though it appears that the regressions would not capture the possibility that openness increased just after wages rose too much and adjustment was therefore necessary because absorption had come to exceed output. In that case, neither the initial wage decline nor the subsequent increase would be attributable to the increased openness *per se*, but simply to a necessary adjustment that was temporally accompanied by that increase in openness.⁷⁰

Using these ILO data, Rama finds no evidence that globalization affected wage dispersion, as widely argued in the literature. He also tests for a wage-dispersion effect using available returns to education data (the indicator is increased income per year of schooling, so it lumps together all levels of education, which may not be ideal here) with the same result. While each of these approaches has its potential flaws,⁷¹ together they weaken any presumption that trade openness *per se* widens wage dispersion and thus suggest that some other phenomenon may be responsible. In that connection, Rama reports that FDI has estimated effects that are qualitatively the opposite of those of greater trade openness. An FDI increase equal to 1 percent of GDP raises wages by 1.5–2 percent after one year, but this effect fades over time and five years later it has disappeared. But FDI does have a huge impact on the returns to education: an increase equal to 1 percent of GDP pushes those returns up by an astronomical 5 percent, consistent with the idea that the “digital divide” effect, if it exists, operates through the technology incorporated in foreign capital rather than (or more than) through trade.⁷² This is

⁷⁰ This possibility could be checked by using a variable for absorption or for current account deficit (not as good) or (best) the difference between absorption and output.

⁷¹ The ILO data do not reflect variance around the average for a given occupation and for that reason could be missing the effects on any change in intraoccupation wage variance.

⁷² Rama (2003) does not refer to any tests of whether the dispersion effect of foreign direct investment is lasting—an interesting question since the overall wage impact is not. If the former does last, the implication would be that after a few years skilled wages would still be absolutely higher as a result of the FDI, while

also consistent with microeconomic evidence of the effects of maquiladoras in Mexico (Feenstra and Hanson, 1997).

Since Rama's study covers the developing world as a whole, its results do not necessarily apply to Latin America, though it creates some presumption in that direction. Future analysis with the same data and methodology for Latin America is desirable. Another limitation of the study is that the data correspond (more or less, at least) to the formal sector, for which countries report wage data to the ILO. In countries where that sector does not account for the greater bulk of employment (that is, in nearly all Latin American countries) these reported wages could behave differently from those for all paid workers or all people with earnings from their labor. Just as analysis of productivity growth can be misleading when the data refer to a typical set of firms, so analysis of wages may be misleading when coverage of workers is partial. It will be important that a study similar to Rama's be carried out using household survey-based wage data.

Openness and employment/unemployment. There are surprisingly few studies of how openness affects the overall quantum of employment. This could reflect a recognition that the quality (including the wage) is more likely to vary than the quantity. Many more studies address its impact at the level of industries presumed to be affected, such as formerly protected industries, but the aggregate effect on employment or labor demand is hard to deduce from those studies.

The growth rate of formal sector jobs in Latin America since 1990 has been about the same as that of all jobs—that is, about 2.15 percent a year. The formal sector's share of all nonagricultural employment has fallen, but agriculture's share has also fallen, and thus formal nonagricultural employment as a share of total employment has just held constant at around 44 percent. If it were possible to maintain the growth rate of employment in

unskilled wages would be absolutely lower. Note also that whereas the estimates of overall wage impact seem quite plausible (for example, a country with a very high 5 percent of GDP entering as FDI would enjoy a wage increase of 8–10 percent), it is virtually impossible that such an inflow could raise the returns to education by 25 percent, since the estimates for such returns typically fall in the range of 5–15 percent. This suggests either that the regression coefficient is upward biased, or that because virtually all of the observations are within the range of 0–3 percent or so of GDP, the regression is (accurately) identifying a large effect within that range of FDI, but an effect that should not be extrapolated outside the actual range of observation of FDI's share of GDP.

the formal sector of a little more than 2 percent a year, this would eventually lead to a gradual increase in its share of total employment as overall employment growth falls because of slowing population growth. The target, however, is better phrased in terms of remunerative jobs than formal sector jobs, since the overlap between the two categories is only partial. (Sometimes, the quality of a job is equated with its being in the formal sector, but this is at best a rough indicator.) By the former criterion the performance since 1990 is harder to judge, but is probably a little weaker.

The acknowledged shortage of good jobs created since 1990 has been interpreted in various ways, but several factors have almost certainly been at work. Most obvious is the slow economic growth at 2.8 percent a year, coupled with still substantial employment growth (2.17 percent a year). This implies a labor productivity increase of only 0.5 percent a year (1990–2003), which virtually guarantees modest growth of good jobs unless there is some very positive structural shift in the labor market and the associated distribution of income. Clearly, this has not happened. It thus appears that, with respect to the more easily measurable aspects of employment performance, such as wage rates and degree of informality, the main causes of weak outcomes have been factors hampering the rate of economic growth and—probably only to a lesser degree—factors affecting the pattern of that growth. A much-discussed possible contributor to the slow growth of good jobs is labor-displacing technological change. Such change has probably led to a significant amount of labor replacement by capital, especially in the declining manufacturing sector, but the main concern may be that this process has not contributed to growth that could offset its direct labor-displacing effects. Blame for that failure might lie with other aspects of the regional economy, particularly the macroeconomic crises triggered by financial liberalization and integration. Liberalization, FDI, and real exchange-rate appreciation have all contributed to the introduction of new technologies that increased the demand for skilled workers and capital. It is important to know which of these changes did what. It is also important to recognize that quite a lot of technological change was inevitable after the lost decade of the 1980s, during which there was so little net investment. There is also the revolution in information and communications technology, whose impact has to be determined.

A second obvious possible cause of employment problems in Latin America has been the increasing dominance of very low-wage (mainly

Asian) countries in world markets for labor-intensive products. This pattern interacts with increasing openness in Latin America to help curtail many of the labor-intensive manufacturing industries, and thus contributes to the observed relative decline of manufacturing in the region.

Labor markets and the institutional structure within which they operate have also received a good deal of attention in the context of weak creation of good jobs. They can affect both the rate and the pattern of growth, as well as other direct determinants of welfare such as job stability and permanence. Some observers blame labor reforms for the weak outcomes, while others argue that there has been little change in this field and that maintenance of the traditional rigid institutional systems is partly to blame. The latter criticism involves at least two main points:

- Labor-market rigidity has probably always slowed growth in the region and contributed to inequality.⁷³
- Such rigidity is especially costly in a more open economy where flexibility of resource use is of greater importance, and hence serious reform is needed in this area.

It is hard to determine the long-term impact of Latin America's labor regimes on growth and inequality and other relevant outcomes, because so many other factors affect these variables and because it is very difficult to assess how binding some elements of the system are.⁷⁴ It is often argued that, to compete effectively in world markets for labor-intensive goods, a country must either have competitive wage levels and a good degree of labor flexibility or be in a position to use the exchange rate as a competitive weapon. At different points in their evolution, countries such as Singapore and Ireland have relied on competitive wages. Many other countries have raised competitiveness through exchange rate devaluations (Berry, 2008c).

Labor-market flexibility has probably been diminished, perhaps seriously, by the currently low inflation rates, well below those of previous decades. Saavedra (2003: 219) suspects that because of lower inflation in the 1990s, labor-market adjustments more often involved the level of employment

⁷³ Saavedra (2003), for example, argues that the creation of good jobs was constrained by labor market institutions that have a history of reducing flexibility and protecting jobs.

⁷⁴ For some further discussion, see Appendix 4.3.

(presumably formal sector employment) than real wages. In this important sense, labor markets may be working less well than before. Such a view is supported by the findings of González (1999) for countries that undertook price-stabilization programs, and by the effects of the recession years since 1997. It is also consistent with Colombia's experience of good growth from the late 1960s onward, and with various episodes of growth acceleration elsewhere involving moderate inflation (10–25 percent) and wage growth's initial lagging of output growth (Berry, 2008c). The Colombian case is of special interest because in the early 1970s, along with an acceleration of inflation from less than 10 percent to about 25 percent and continued strong economic growth, there occurred (i) an initial fall in the real wages of a number of groups (since indexing was limited) and an only gradual recovery in those wages; (ii) strong employment growth and falling unemployment; and (iii) according to most studies, a decline in the level of urban inequality, one of the very few more or less confirmed declines in Latin America over the last several decades. The argument that either inflation or reductions in observed real formal sector wages leave the poor behind is not supported here, at least as far as the urban poor are concerned. Some wages fell in real terms even as the economy was moving into its rapid growth period, which perhaps helps explain why employment growth was fast (in manufacturing SMEs, for example) during that period (Cortes and others, 1987).

The question of interest here—how increasing openness affected labor demand—is so closely intertwined with some of the other possible causes of Latin America's weak employment record that it must mainly be studied simultaneously with them. This is true with respect to exchange-rate management, labor-market policy, and technological change. Macroeconomic stability and low inflation rates were sought in part for their own sakes, and in part to create a positive context for economic integration. The process of opening is thus partly to blame for some of the labor-displacing technological change (as when it is sought in order to improve competitiveness in foreign markets), for some of the loss of labor-market flexibility due to very low rates of inflation, and for some of the vulnerability to competition from low-wage countries (which now outcompete Latin American producers in local as well as world markets). In principle, greater openness can be used in ways that do not put an economy at such high risk from these employment-reducing factors. The East Asian tigers were obviously successful in this regard. They competed aggressively in world markets but provided selective protection to

their own markets, they did not pursue such tight macroeconomic policies, and they achieved very high growth and dramatic economic improvements for their workers. It is true, however, that their labor markets were notably more flexible than those of Latin America are believed to be and that labor legislation was much less openly protective of workers' rights, although it is not at all clear if this was true of the policy systems as a whole. In South Korea, although strikes were long forbidden and formal labor legislation was not overtly protective, policy (especially under President Park) included pressure on business to share the fruits of growth with the workers (Amsden, 1989).

Probably the strongest reason not to expect opening to trade to have a positive effect on labor demand is that, with the world's low-wage countries now large traders, for practical purposes Latin America is no longer a low-wage region relative to the newly defined trading world of which it is a part. What the East Asian tigers could do earlier and Vietnam can do now—that is, take advantage of their low-wage status—is something that Latin America cannot do. Chile, the region's greatest trade-based success in the last two decades, achieved its success through a combination of public sector support for research and development and investment in such new areas as salmon and fresh fruits, a devaluation that helped induce more products into the export column, and a policy framework that supported private sector initiatives in general. Exports have grown very fast and the number of export items has surged, making the country much less reliant on copper (French-Davis, 2002). But this success is not built on the production of labor-intensive tradables—in fact those manufacturing activities that are labor intensive have lost ground (Berry, 2008a)—and the level of inequality now appears to be a good deal higher than it was during the import-substituting phase up to 1970.

Short- and long-run effects and the relevance of speed of change to the distributional aftermath of integration and reforms. A point made strongly by the proponents of economic opening is that any overall guess as to its impact on labor-market outcomes must distinguish between the shorter and the longer terms. The more easily identifiable effects in the short run may be the negative ones, as formerly protected jobs disappear with the dismantling of protection, and macroeconomic performance may be weakened because of uncertainty about the new rules of the game and how to behave under them. Because of the possibly lengthy delays before the full potential benefits emerge, the process of change must be monitored in an effort to detect those benefits (or

the mechanisms that will eventually produce them) early, rather than wait too long before perhaps concluding that they will not in fact emerge.

Apart from what it is that changes in an economy (whether in response to policies or not), the speed of that change may influence the result, as was often stressed in the debates on how reforms should be carried out in the former Soviet Bloc countries. Reviewing the experience of Costa Rica, where trade and other reforms were carried out gradually (with persistent concern for the possible social costs) and had to be negotiated in a democratic context, Gindling and Trejos (2003) see no evidence of income concentration, but rather some mild tendency in the opposite direction. Data on the functional distribution of income show a fairly continuous upward trend in the human capital share, from about 40 percent in 1976 to 55 percent by the mid-1990s (Gindling and Trejos, 2003), while unskilled labor's share was falling from 15 percent to less than 10 percent.⁷⁵ Such a large increase in the former share would undoubtedly have raised inequality had it occurred within a short period.

Like almost everything else, the optimal pace for the introduction of reforms probably depends on the country and its conditions, and also on the reform in question. It is clear that many countries opened their financial systems too early, too fast, or before taking necessary prior steps. It will be some time before any very credible conclusions can be reached in this area because it is extremely difficult to set up plausible counterfactuals.

4.5 Summary

Latin America as a region grew rapidly in the 35 years between the end of World War II and 1980. It performed either very badly (the 1980s) or unsatisfactorily (from 1990 to the early years of the present decade) for a quarter century, and in the process slipped far behind the fast growers in East Asia. Not surprisingly, this failure—in comparison with both the earlier ISI period and with some other parts of the developing world—has fueled a good deal of frustration and unrest. There have been several interesting policy innovations, and progress has been made in some social areas, but in most countries and

⁷⁵ The estimated physical capital share rose with fluctuations before 1986, including a big increase at the expense of human capital over the 1980–2 crisis period, and then fell somewhat after the reforms. Given the incomplete reporting of capital income, the reported behavior of this share must be taken with a grain of salt.

the region as a whole the institutional response has not been enough thus far to alter the trends significantly. Still, it is possible that the seeds of some significant future social and economic progress may already have been sown.

Drawing on the above review and other analyses, this section summarizes my best guess as to the growth, distribution, and poverty impacts of the greater economic integration of Latin America.

First, average per capita income would be higher in the region, and in most of its larger countries (with the probable exception of Chile), if policy had shifted less sharply toward openness and if the industrial world had allowed the region to work its way out of the debt crisis in which most countries found themselves at some point in the 1980s. The cited forbearance on the part of industrial countries would have involved some combination of writing off debt and extending credit to allow a gradual exit from debt crisis, but without forcing or greatly encouraging the policy shift toward openness. This is not to say, of course, that countries would be better off today had they defaulted and thereby cut themselves off from international finance; that is a different and more complicated question. Basically, it is to disagree with the proposition that the ISI model in Latin America had universally run out of steam and thus had to be drastically altered in the form of a free trade and capital movements model. That contention never had much general validity. In the late 1960s, both Brazil and Colombia diminished the antiexport bias of their trade regimes, thereby moving closer to the East Asian model in which exports are encouraged but selected industries are simultaneously protected in the domestic market. It is probable, however, that the performance of some Latin countries was hampered by a badly designed and/or badly executed ISI strategy, and that for them the shift toward openness was beneficial. The most successful countries during the heyday of ISI tended to be the larger ones, particularly Brazil, Mexico, and Colombia. Almost certainly, then, the implications of the shift have varied considerably from country to country.

Even if the effects of increased openness thus far are judged to be negative, it is possible that they will eventually become positive—that is, that the region's average income has not been permanently lowered by an exaggerated rate of opening up. Any judgment on this matter is highly speculative, since it depends, among other things, on the policy sequence that will in fact occur in the future (an unknown) and that which would have taken place had the reforms been less extreme (another unknown). But enough ground has already been lost to make it a risky bet that the region will, even over the next several

decades, catch up to where it would have been had the debt crisis not initiated its downward spiral. Per capita output is now about half what it would have been if the 1950–80 growth rate had been maintained since then.

The main culprit in the growth slowdown appears to have been free capital movements rather than freer trade. Opening up the capital account produced a series of financial and currency crises in Latin America (and elsewhere in the developing world), which had severe growth consequences. The effects of trade liberalization on growth have probably varied considerably by country, and on average been fairly small.

It is possible that the balance between the positive and negative growth impacts of open capital markets will also change over time, as domestic financial systems become less fragile, better supervised, and so on. But there remains a reasonable underlying doubt as to whether access to short-term capital from abroad is in any case a good thing in most developing countries, given its tendency to be volatile and the damaging effects that volatility can have on the real economy, especially through the propensity for overvalued exchange rates. It also appears to be true that integration with the world capital market can widen the gap in access to capital among firms, by lowering capital costs to those (mainly) large firms able to operate in that market (including, of course, multinational corporations) while not improving the access of smaller domestic firms. Within the domestic market, therefore, the degree of capital market imperfection may increase.

A reasonable guess is that greater openness has been at least partly to blame for increased inequality in those Latin American countries that have suffered it in various periods, such as Argentina, Chile, Colombia, Ecuador, and Mexico. If most of the recorded worsening was due to greater openness, then the impact was sometimes quite significant, since in several countries the Gini coefficient increased by up to 5 percentage points, which is large relative to the typical variation of this indicator. One of the likely mechanisms on the trade side is that openness has encouraged labor-displacing technological change, by reducing the price of capital goods, by encouraging the use of modern technology to produce the quality levels required in rich countries, and by other means. The possibility that capital account liberalization has contributed to rising inequality is harder to assess, partly because capital incomes are less fully and accurately measured than labor incomes, and partly because the possible mechanisms that might link this form of liberalization to inequality have been little

studied.⁷⁶ Several country studies (for example, Yeldan, 2004; Rodríguez, 2004) conclude that financial liberalization has had significantly regressive effects. Cross-country studies have reported mixed results, but it is hard to assign much credibility to them, for reasons discussed above.

If the reforms had a negative or, at best, neutral impact on growth and a negative effect on distribution, it follows that for the region as a whole they have impeded the reduction in poverty that otherwise would have occurred. By most definitions, in fact, even after the growth recovery since 2002, poverty incidence has only recently returned to where it was at the start of the crisis in the early 1980s.⁷⁷ Chile is an exception to this unhappy generalization.

The international response from the World Bank, the IDB, and ECLAC to the region's struggles has included not only a more direct focus on poverty as a policy variable but also considerable discussion of inequality as a problem in the region. The countries themselves have gradually accumulated and developed policies designed to reduce poverty. In many cases the 1980s were taken up by survival efforts, a focus on contemporaneous macroeconomic problems (putting out fires without accompanying preventive planning), and a slowly rising awareness of the contours of the new situation. There was little time or effort, and few resources, to be devoted to designing a response to the social crisis that accompanied the economic crisis. But eventually, with considerable external involvement, some interesting responses did emerge. Some have clearly had beneficial effects; some may have been pernicious; in other cases it is hard to tell. Some have received support from the IFIs, while others have not. The main conclusion that can be drawn at this point is that, to the extent that some of these policies have had the expected favorable effects on distribution and poverty, for the most part they must have been offset by equally strong pressures working to disequalize income and raise poverty. They may have been good policies

⁷⁶ One of the more obvious possible mechanisms involves the above-mentioned fact that international financial integration typically lowers the cost of capital for the large firms operating in a country but not (or not so directly) for the small ones. It may thus encourage capital-intensive firms at the expense of labor-intensive ones.

⁷⁷ Berry and Serieux (2007) report that with a poverty line of 1,500 1985 international dollars, poverty incidence rose from 21.8 percent in 1980 to 31.6 percent in 1990, and to 32.8 percent in 2000. Different poverty lines show somewhat different trends. ECLAC (2006) reports poverty incidence of 40.5 percent in 1980, 48.3 percent in 1990, 44.0 percent in 2002, and 39.8 percent in 2005, when the level finally returned to that of 1980.

but they have not been able to reduce poverty significantly according to the data available, which suggest that, with inequality tending to increase since 1990, reductions in poverty have been modest and fitful (depending on the poverty line used). Poverty has fallen sharply in Chile and probably in the Dominican Republic as a result of fast growth. Declines in inequality have been too rare to account for a significant part of the reductions in poverty where they have occurred.

What can be said about the various policy steps taken? What, if anything, might have worked better? It is useful to distinguish the main policy direction—market-friendly reforms, the various types of complementary policies (palliatives, some would say), and any alternatives that have not been tried in any significant way but that might have worked better than the policies adopted.

Increasing Integration and Furthering Market-Friendly Reforms

The disappointing performance of the region as it became increasingly integrated into the world economy probably owed less to a misidentification of the weaknesses and inefficiencies that the reforms tried to address (although there was certainly some of that, as discussed above) than to an excessive optimism about what markets, operating in the local institutional context, could do. The readily observable weaknesses of governments suffering from incompetence and corruption were too often compared to the simple textbook case of an economy operating under market principles.⁷⁸ Perhaps the most egregious example of this was the optimism about how the deregulation of capital markets, domestically and internationally, would raise savings and improve access to and allocation of capital. In a perfectly competitive world (the simplest textbook case), this would have happened; but it has always been known that, of all the various types of markets that exist, it is the capital markets that neither do nor can (for various structural reasons) approximate pure competition. So finding that liberalization led to financial crises should

⁷⁸ A source of optimism among the promarket reformers has been the hope that increased democracy, less government, and more open markets would bring a detectable decline in political corruption, which has long been blamed as a factor contributing to inequality in Latin America. But Tulchin and Espach (2000) note that, here too, events have not conformed to the reformers' hopes. The reforms, especially the privatization component, were seldom carried out in a transparent way and were notably corrupt in Brazil under Collor de Mello and in Argentina under Menem.

not have been a surprise, and it was not to more astute observers such as Díaz-Alejandro (1985).

Still, there were some legitimate grounds to expect that raising the level of economic integration and combining this higher level with better complementary policies would lead to a stronger performance and to convergence of per capita incomes toward those of the developed countries. Hence the idea, for example, that a Free Trade Area of the Americas (FTAA) would contribute to a convergence of incomes between the United States and Canada at the high end and the other countries of the region at the lower end, an idea based partly on simple trade theory and partly on the internal experience of countries like the United States and Canada. By now it is clear that the sort of integration that has taken place thus far does not ensure quick income convergence—in fact, there was some further divergence in the Americas over the 15 years (approximately the postcrisis period) following the sharp divergence of the 1980s.

Proponents believe that convergence is a matter of time and of “deeper integration”—hence the continued support for an FTAA, even though the furthering of integration thus far has clearly not had the desired effects. Part of the issue involves the interpretation of historical convergence processes within a number of countries. Doubters worry that even if barriers to trade and the movement of capital are completely removed (as they usually are within a country), this may not be enough to bring about convergence. This could be the case if the free movement of labor is the real key to intracountry convergence, or if capital mobility is beneficial only when the countries of a region share a currency, thus obviating the risk of a currency crisis. It has been widely noted that an additional feature of the European Union (and the same applies *within* most countries) is a system of transfer payments from richer to poorer countries or regions. This might simply act as an income equalization transfer system and/or it can be viewed as a mechanism to facilitate the adjustments necessary when a poorer region integrates with a higher-income region. Such a system is absent in the North American Free Trade Agreement, though the idea has been floated occasionally, and in the current plans for an FTAA.

On the evidence to date, it seems unlikely that increasing integration will lead to a reduction of inequality in Latin America even in the medium term and even if the countries of the region eventually achieve a creditable growth performance. Early optimism about declining inequality has been

quelled, and deeper analysis of some of the mechanisms linking the reforms to inequality has removed some of the main sources of optimism—for example, that labor-intensive exports would quickly raise blue-collar wages or that an end to financial repression (overregulation of capital markets) would greatly improve the distribution of capital, to the benefit of smaller producers, who are systematically more labor-intensive than larger ones. Hence it has become increasingly accepted that the impact of integration in Latin America today is probably quite different from the impact in East Asia a few decades ago. Latin America's comparative advantage lies more in natural resource exports or goods intensive in relatively skilled labor, whereas those of the East Asian success stories lay in unskilled low-wage labor. Also, Latin America does not display the East Asian-type density of SMEs and even less their linkages with manufacturing exports. Thus only when the combination of a natural resource and labor have produced the good (as with Colombian coffee produced on small farms) have the benefits of trade accrued substantially to lower-income people. Often, however, as with the current production of soya in Argentina, Brazil, and Paraguay, comparative advantage lies in the natural resource (land), but little labor is used. In such cases, even if increased trade were to bring about the convergence of average incomes across countries, it would not raise unskilled wages in Latin America and might well lower them. It remains true that if integration could produce growth rates of about 6 percent or higher, income poverty would be reduced even if distribution worsened somewhat further. Overall, however, in light of the continuing failure of the current strategy to produce more than a single year's regional growth as high as the 5.5 percent average in the period 1950–80, ever more attention has been paid to other policies that might improve distribution and thereby reduce poverty.

That Latin America's greater international integration has not brought the promised benefits does not mean that it has no supporters in the region, nor that it might not produce many benefits to countries under better circumstances. Improvements could be made in the:

- Continuing protectionism of many industrial countries, often in products of much interest to exporters from Latin America and elsewhere
- Excessive push toward openness for Latin America, when a better mix is likely to be that pursued by most of the successful East Asian countries—a strong export orientation combined with selective protection of the domestic market for “infant industries”

- Destabilizing macroeconomic effects of high levels of trade and capital market integration with an industrial world that causes instability but does little if anything to alleviate its effects in Latin America (Ocampo, 2005)

Each of these problems reflects the asymmetrical power relations between Latin America and the United States, part of a similar asymmetry between developing countries in general and the industrial world.

Complementary Steps and Their Payoffs

Several noteworthy policies warrant mention here, including microfinance systems, support for human capital formation, health care, pension systems, unemployment insurance, macroeconomic policy, financial reforms, and improved governance. Most of the advances in these areas are unlikely to have a great impact on distribution and poverty in the short term, though some probably will in the longer term, especially if they are better managed as time passes.

Macroeconomic policy for stability has been emphasized by the IFIs as important, in light of many Latin American countries' inflationary histories. It is not clear, however, whether it matters much that inflation be very low (say, 5 percent) as opposed to moderate (say, 10 percent). Reasonable price stability probably helps growth in some instances and may also be good for distribution, but it is unlikely to make much difference in the absence of other good policies, and if pushed too far it may be harmful to growth. And evidence is mounting that low levels of inflation can damage the efficiency of the labor market as an allocator of resources.

Financial reforms may eventually give rise to improved economic performance, but typically they have not had that effect in the short run, except in Chile and perhaps one or two other countries. Both domestic and international financial liberalization have led to growth-destroying crises. Even when the new and less regulated systems have become less vulnerable to shocks than they were initially, as many now appear to be, there is a serious possibility that they will be harmful to equality—as suggested by the WIDER research project carried out by Cornia and Court (2001)—and unhelpful to growth. The “free-market” allocation of financial resources often channels them to consumption, commerce, and other short-term uses. The reforms have been undertaken more to improve systemic stability

than to promote development, except in the loose sense that there has often been a belief that market allocation would be efficient allocation. Given the myriad and often unavoidable imperfections in the capital market, this is a heroic belief. Interventions should be designed to build on market forces as much as possible, for example, by encouraging more lending to SMEs using market-type incentives, but this does not mean that free markets are likely to be efficient.

Education has long been identified by analysts as an important determinant of income inequality. Specifically, a large proportion of the differences in people's labor incomes is associated with different levels of education. In fact, if a society cannot or chooses not to reduce inequality through land reform (as happened most notably in Japan, South Korea, and Taiwan), the distribution of education is the next most obvious instrument that might be used to that end. The main hope is that inequality can be reduced by raising the level and quality of the education given to those toward the bottom of the income distribution. There have been significant increases in average years of schooling for lower-income deciles during recent decades in Latin America, but these efforts have not resolved the problems of inequality and poverty. Perhaps there will be significant benefits in future. But little medium-term optimism seems to be warranted in this area, because it appears that the clear progress made on quantity has not been matched by progress on quality. Primary schooling remains very deficient for the children of most poor families in Latin America. Additionally, if education is to be the variable that lowers inequality, the improvements at the bottom of the income hierarchy must exceed those at the top, and it might be hard to narrow the gap even if the government did its job well at the bottom of the income distribution, since better-off families can use the private system to maintain the gap.

Microfinance has become an important phenomenon in Latin America and in the developing world over the last few decades (Westley, 2001). The IDB has been a long-time and prominent supporter of it. Its most open critics are probably those on the left, who see it as a new palliative against the excesses of capitalist growth but one that is useful to the beneficiaries of such growth, since it prevents low incomes from becoming too low. In any case, the advent of microcredit as a sustainable component of the financial system, without large (and sometimes without any) subsidies, has been a breakthrough. The question now is, will it do a lot or just a little to reduce poverty and inequality? On this question, for Latin America and the rest of the developing world,

the jury is still out—if one defines the jury as comprising those who know something of the phenomenon but can still be dispassionate about it. The main issue is whether the undoubted benefits received by many small borrowers are mainly at the expense of their direct or indirect competitors in whatever markets they are found. If so, then the overall impact on poverty, for example, may be much less than the optimists believe it is. The best studies, however (for example, Khandker, 1998), are reasonably reassuring. But microcredit cannot be expected to pull people far out of poverty; other instruments are needed to do that.

Three areas where policy might have important and direct poverty-reducing effects (as opposed to the indirect effects of policies that raise earned incomes) are improved health care, unemployment insurance and pensions, or other transfers to low-income people. As regards how to provide resources to lower-income families, an important issue is whether to target programs specifically toward them.

In the area of *health care*, the large socioeconomic gaps and the administrative inefficiencies of most governments created a legacy of problems for lower-income families. These led to large interclass differences in life expectancy, child mortality, and general morbidity, as well as to lower average life expectancy than in poorer but more equitable countries elsewhere, such as China (before the reforms) and Sri Lanka (Abel, 1994). Early 1990s studies by the Pan American Health Organization estimated that nearly 130 million people in LAC (of a total population of about 450 million at the time) had no access to health care. The structural adjustment policies that governments were forced to pursue because of the debt crisis put health systems under severe financial strain, and the policy preferences of the newly involved IFIs (in this case the World Bank and the IDB) were toward user charges and cost sharing. It is unclear how well the health systems have performed in the postcrisis period in terms of the quality of coverage for lower-income people. Abel (2003) bemoans the lack of research on this issue. He suspects that the neoliberal reformers' optimism that the changes would raise efficiency and welfare have not been fulfilled, and that the power structures within the health sector are even more stratified than in the late 1970s. Nonetheless, life expectancy has continued to increase, as it did even during the darkest days of the last decade of the 1980s. It is not at all certain how positive a conclusion can be drawn from this, since this variable's trajectory tends to depend more on past investments than on current ones.

As to *unemployment insurance*, a key component of the social safety net in industrial countries, there is little reason to believe that it can make a large difference in most Latin American countries. Several have introduced such systems in recent years, including Chile, Argentina, and Brazil, but seldom do more than 10 percent of the unemployed receive benefits.⁷⁹ The large size of Latin America's informal sector seems to render almost irrelevant the type of system found in industrial countries, where prior formal employment is a precondition for receipt of benefits. The challenge of mounting a transparent and fair system would also be great. A system based on individual accounts (which lacks the industrial-country system feature that those who suffer little employment subsidize those who suffer more) has potential, and is currently used in Chile, but mainly for middle-income earners. For some time, therefore, job instability will continue to be tackled mainly through employment policy (see below).

Pension systems for low-income retirees, by contrast, do offer much potential, as evidenced by Brazil's rural social security system, which was implemented in 1992 as a result of the new constitution of 1988. A previous system established by the military government after 1964 paid half a minimum wage to family heads over 65. The 1988 constitution expanded coverage to men over 60 and women over 55, allowed both spouses to receive the benefit, and increased that benefit to one minimum wage. The only condition was that those seeking the pension had to demonstrate that they had worked in agriculture, fishing, or forestry for a period of five years (later raised to 102 months). Morley (2001) notes that by distributing 1 percent of GDP to the retired rural poor, independent of any earlier contributions to social security, this system has markedly reduced poverty. Most current pension systems in Latin America involve transfers to higher-decile families and have been both expensive and somewhat regressive.

Targeting has been a key element of the policy response to the shortage of funds, beginning with the debt crisis suffered by most countries of the region. In principle it allows a given expenditure to effect more poverty reduction than otherwise by avoiding the "leakage" of benefits to the nonpoor. Possible problems include limited political support, when the poor have little political weight, and institutional opposition. In what Márquez (1995) describes as "the most important initiative by a Venezuelan government to support low-income

⁷⁹ Communication from Adriana Marshall, referring to the late 1990s.

groups in a time of crisis,” the government chose to circumvent the resistance of vested interests in the traditional social service agencies by creating a completely new apparatus for delivering focused services to poor people. New channels untainted by corruption were quickly set up, but efforts to expand the programs to the national level tended to be thwarted by the opposition of public sector unions. Contexts vary a great deal in this and other respects.

Other Policies That Might Have Worked Better Than What Has Been Tried

What set of policies might have produced significantly better distributional, and hence poverty, outcomes in Latin America in the wake of the Washington Consensus reforms? Developments have confirmed that the steps taken to complement those reforms and/or to offset some of their negative impacts have not been adequate to this task. Several alternative policies, including the following, might have proven more successful.

Land reform and/or support for small agriculture. Much poverty in Latin America is still concentrated in rural areas, and the countryside’s share of the poor was considerably higher when the reforms were introduced a quarter century ago—well over half. The first and arguably most important policy that put South Korea and Taiwan on the path to fast and equitable growth was land reform, which contributed to efficient small agriculture. There have been only a few significant land reforms in Latin America, a circumstance that goes a long way toward explaining the region’s historically extreme levels of inequality. Even where redistributive land reform is not feasible, strong support systems for small farmers can be a very important tool against poverty. Some countries have performed satisfactorily in this regard but most have not, and in many countries support for smallholders has shrunk in the wake of the debt crisis and market reforms that shifted some elements of support from the public to the private sector. The World Bank, which until recently was not a supporter of land reform, has begun to assist market-based reforms over the last decade (Deininger, 1999). While worthy enough in themselves, these alone are unlikely to have a significant aggregate impact on land distribution and hence on inequality and poverty. They are, nonetheless, a desirable component of a broader-gauged reform program, as in Brazil, where the president has had great difficulty fulfilling his electoral promises to the Movement of Landless

Rural Workers (which represents about 4 million landless families). By now, in any case, the region has become sufficiently urbanized that the potential impact of land reform or any other agriculture-related policy is substantially less than it was in South Korea or Taiwan when those countries were setting the stage for their dramatic successes. It remains an important component of any strong antipoverty strategy, but in modern-day Latin America it is not such a dominant centerpiece of that strategy as it was historically in East Asia.

Support for SMEs. A counterpart to a good small-farm policy in a mainly agricultural economy is a good SME policy in a mainly nonagricultural economy, which most Latin American countries now are. The East Asian success stories (especially Taiwan) again provide the benchmark; they relied heavily on smaller enterprises and designed good support structures for those firms. Although such support is increasingly part of the policy rhetoric in Latin America, the region has generally not approached the task with due seriousness, and hence the SME sector has not provided the needed motor for growth and equity. A general feature of the postreform period has been a widening productivity gap between larger, more modern firms and smaller, more traditional ones (Stallings and Peres, 2000). Support for microenterprises, while helpful, is not a substitute for support for SMEs, since the latter sector has the potential to provide substantially more remunerative jobs than do microenterprises. Some countries have made interesting forays into this area, setting up business development centers and other sensible-looking initiatives. There is too little evidence to say what combination of policies would work best here, but in most cases it is clear that progress has been very limited.

Exchange-rate policy. There is much evidence that the real exchange rate can be a more important determinant of the growth of exports and, more generally, of tradables than can trade policy, and it is likely to be a key element of effective growth strategy in many countries (Bruton, 1989). Despite this, an undervalued exchange rate has not received much attention as an option in Washington Consensus circles or in most Latin American countries. Given the countries' history of inflation and the need to fight it, many policymakers in the region had come to think of the exchange rate as a variable that could be used to that end rather than as a tool for growth. Meanwhile, the IFIs have tended not to advocate policies like undervaluation that cannot be pursued simultaneously by all countries. Still, most of the dramatic growth

successes built on exports have relied significantly on this policy instrument (Berry, 2008c). China has been using it to great effect recently.

Overall employment policy. One of the legacies of the debt crisis and the neo-liberal shift in economic thinking, both in Latin America and generally, was a decline in the attention paid to employment policy. Under the Washington Consensus proposals, good growth was expected to bring with it good labor-market outcomes. And labor-market interventions such as rigid rules on the firing of workers were generally frowned on as counterproductive. In fact, when and where good growth has occurred over the last couple of decades, it has often not been accompanied by good labor-market outcomes, partly because it has come with labor-displacing technological change. It was thus premature to downgrade employment policy. Given the great challenge on this front, Latin American countries would do well to put such employment policy center stage, beginning with the sort of broad-gauged analyses pioneered in the 1970s by the ILO's World Employment Programme (ILO, 1970) but seldom followed up in later years—though one valuable effort was the Chenery Mission in Colombia (Ocampo and Ramírez, 1987). Partly because nearly all policies affect employment, it is hard to ensure coherence in this policy area—unlike in the tax field, for example, where one ministry oversees everything.

Reversals of Washington Consensus policy overshooting. It is an open question whether adoption of all the promising approaches that have been tried or might be tried to make the new model work satisfactorily would lead to success. Few countries would be both able and willing to undertake them all. This leads us back to a final, related question: might it be necessary to reverse some of the Washington Consensus policies to achieve success? At the moment, no one can answer this question with much credibility. But two most obvious corrections to the Washington Consensus policy overshooting are worth mentioning. The first is a prudent withdrawal from full financial integration with world capital markets, especially until the risks of financial crises brought on by such openness are greatly reduced and other negative effects on the financial system's contribution to development are dealt with. The second is a strengthening of industrial policy, using trade protection as necessary. An integrated "industrial policy" of some sort may be necessary to provide the policy coherence and degree of certainty required by private agents if they are to invest at needed levels (Carnegie Council on Ethics and

International Affairs, 2005; Rodrik, 2004). Free trade does not remove all the tools of industrial policy (others are credit policy, infrastructural support, and technology support), but it does remove the one that may be easiest to implement in many countries. Some Latin American countries did not use protection well in the earlier ISI era but others seem to have done so, at least as judged by the crucial criterion of the economic growth rate. At present, with the other instruments playing relatively larger roles in the industrial policies that countries do implement or try to implement, it is hard to judge from empirical evidence how much of this countries are doing, how coherent it is, and so on. Since such policies go against the grain of the market-friendly reforms, there is a tendency to disguise and downplay them to avoid the disapprobation of the IFIs. This may make it harder to achieve coherence among elements of the policy. One way to phrase the challenge now facing many Latin American countries is that they need to accelerate to high and sustained growth after a lengthy period of slow or modest growth. Most countries around the world that have met this challenge in the last 40 years have used strong industrial policies (Berry, 2008c).

The Ultimate Need: Leadership and Statesmanship

Intriligator (2004) believes that globalization would probably have positive effects in a cooperative world, whereas in a world beset by many conflicts its net impact is more likely to be negative. He recalls the Americans who were instrumental in creating the new world system in the West between 1945 and 1955 and suggests that a comparable level of statesmanship is now needed to effect deep reforms of the current international apparatus. If the sort of “wise generosity” that was on display half a century ago were present now it would focus, among other things, on the need for new institutions to deal with international financial instability and with the huge inequality of income among the countries of the world. In his judgment it would require more than what the World Bank is now doing in the latter regard and a substantial increase in resources for the IMF or for a similar institution charged with maintaining the stability of the international financial system. It would have to search hard for ways to regulate and control some of the pernicious influences of the current world economic system, especially the defects of the international financial system. It would, in short, need both good analysis and strong leadership.

In the absence of such leadership at the world level, or in the United States, as judged by the currently ongoing financial crisis,⁸⁰ it behooves the countries of Latin America to push for institutional changes that would locate more of the power to make decisions about international economic mechanisms in the region rather than in the industrial countries (and in Washington in particular). That leadership has to be open to policy experiments and support the more promising ones, while being aware of the risks that most experiments entail.

⁸⁰ At the time of this writing, the U.S. government is belatedly beginning to implement a plan to mitigate the fallout from its grotesquely unregulated financial system, in part following the leadership of the United Kingdom. Unless major policy changes occur quickly in the United States, it is unlikely to be able to provide the leadership or even the collaboration that Latin America needs at the international level.

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APPENDIX 4.1

Statistical Tables

■ **TABLE 4A.1** Trends in Urban Participation Rates by Gender and Age Category, 1990–2002: Major Countries

Country	Year	Men					Women				
		All	15–24	25–34	35–49	50+	All	15–24	25–34	35–49	50+
Argentina	1990	76	62	97	97	55	38	41	53	52	19
	2002	75	52	96	98	63	48	40	66	70	28
Bolivia	1989	73	47	90	97	64	47	35	57	61	34
	2002	77	51	93	98	75	57	39	71	75	49
Brazil	1990	82	78	96	95	59	45	48	56	53	21
	2001	79	70	94	93	59	53	52	67	65	29
Chile	1990	72	47	94	95	56	35	29	47	46	20
	2003	73	41	92	96	64	45	31	61	59	29
Colombia	1991	81	62	97	97	69	48	44	63	56	22
	2002	79	61	96	96	65	57	51	76	72	32
Costa Rica	1990	78	62	96	95	61	39	39	53	49	14
	2002	77	57	97	97	61	46	37	63	60	25
Ecuador	1990	80	56	95	98	78	43	33	54	56	31
	2002	81	60	96	98	74	53	40	65	67	41
El Salvador	1990	80	64	95	96	72	51	41	66	66	34
	2002	73	52	92	94	61	51	35	67	70	35
Mexico	1989	77	58	96	97	68	33	31	45	39	18
	2002	79	59	95	96	70	45	36	55	57	29
Uruguay	1990	75	68	98	97	54	44	47	69	64	21
	2002	72	63	96	96	51	50	47	76	76	28
Venezuela	1990	78	55	93	96	71	38	25	51	52	21
	2003	83	65	96	98	75	56	42	71	72	37

Sources: ECLAC (2004a, 2004b).

■ **TABLE 4A.2 Gender Differences in Urban Unemployment Rates, 1990–2003:**
Selected Latin American Countries

Country	1990	1995	2000	2003
Argentina	7.3	18.8	15.4	16.4
male	7.4	16.5	17.2	17.1
female	7.3	22.3	14.0	15.4
gap ^a	−0.1	5.8	−2.2	−1.7
Brazil	4.8 ^b	4.6	7.1	12.4
male	4.8 ^b	4.5	6.5	10.1
female	4.9 ^b	4.8	8.0	15.1
gap ^a	0.1 ^b	0.3	1.5	5.0
Chile	7.4	6.6	9.2	8.9
male	6.6	5.5	8.7	8.2
female	9.2	8.9	10.0	10.1
gap ^a	2.6	4.4	1.3	1.9
Colombia	11.0	8.6	20.5 ^c	16.3
male	8.3	6.8	15.0	14.6
female	14.7	11.3	19.9	20.3
gap ^a	6.4	4.7	4.9	5.7
Mexico	2.7	6.3	2.2	3.2
male	2.6	6.1	2.1	3.1
female	3.0	6.5	2.4	3.4
gap ^a	0.4	0.4	0.3	0.3
Peru	8.5	7.9	7.0	9.4
male	6.5	7.2	6.9	8.4
female	11.4	9.1	7.1	10.7
gap ^a	4.9	1.9	0.2	2.3
Venezuela	11.0	10.3	13.9	18.9
male	11.4	8.9	13.2	17.0
female	10.4	12.9	14.8	21.7
gap ^a	−1.0	4.0	1.6	4.7

Source: ILO (2003).

^a Female unemployment rate minus male unemployment rate.

^b 1991.

^c The overall unemployment rate reported is inconsistent with those for men and women. Probably there is a typographical error in the source.

■ TABLE 4A.3 Composition of Nonagricultural Employment in Latin America by Economic Activity and Gender, 1990 and 2002

Year/ Gender	Goods sector	Manufacturing, mining, utilities	Construction	Services	Trade	Transport	Finance and others	Social, personal, and community services
1990								
total	28.8	21.7	7.1	71.2	24.0	5.7	5.0	36.2
men	36.2	25.0	11.1	63.3	23.1	8.3	5.2	26.7
women	16.9	16.3	0.6	83.0	25.4	1.4	4.7	51.4
2002								
total	26.1	19.6	6.5	74.1	26.5	6.8	4.8	35.8
men	33.5	22.3	10.9	66.7	25.8	10.4	5.2	25.1
women	15.8	15.3	0.5	84.3	27.7	1.8	4.3	50.4

Source: ILO (2003).

■ **TABLE 4A.4** Changes in the Composition of Urban Employment, by Public/Private, Establishment Size, and Country, 1990–2003:

Country/ Year	Paid workers					Independent workers and unpaid family helpers		
	Employers	Private sector						
		Total	Public sector	Nonprofessional and technical		Total	Nonprofessional, technical	
				Professional and technical	Establishment of > 5 workers	Establishment of up to 5 workers	Domestic service	
Argentina								
1990	5.4	69.0	18.0 ^a	6.9	44.8	11.6	5.7	22.9
2002	4.2	73.5	17.6	12.4	22.9	15.0	5.6	17.5
Bolivia								
1989	2.2	53.9	17.9	4.3	16.3	9.6	5.8	41.0
2002	4.3	47.6	10.4	4.6	15.5	13.2	3.9	45.7
Brazil								
1990	5.2	72.0	—	14.3	—	—	6.2	21.5
1993	4.1	67.2	14.4	4.6	31.5	8.5	8.2	26.4
1999	4.7	66.6	13.0	11.0	25.7	8.4	8.5	26.5
2001	4.6	68.8	12.7	11.6	—	—	8.8	24.4
Chile								
1990	2.5	75.0	— ^b	12.9	45.7	9.4	7.0	20.6
2003	4.1	75.7	11.4	12.1	38.3	7.2	6.5	15.0
Colombia								
1991	4.2	66.2	11.6	4.9	44.1 ^c	—	5.6	27.3
2002	5.1	53.6	7.6	4.3	35.8 ^c	—	5.9	38.5

Continued on next page

■ **TABLE 4A.4** Changes in the Composition of Urban Employment, by Public/Private, Establishment Size, and Country, 1990–2003:
Selected Countries (*continued*)

[illegible]

Sources: ECLAC (2004a, 2004b).

Note: Although data are presented for Brazil in the source, several of the categories used here are not distinguished for 1990 and some figures in any case appear to be unreliable. The partially overlapping information of ILO (2003) also has some strange features, but appears more plausible. — = data not available.

^a Estimated on the basis of a figure presented by Saavedra (2003: 235), since the figure was not given in the main source.

^b These two figures together total 75.0.

Nonprofessional or technical workers in plants of up to five workers are included here since the source did not distinguish the two groups.

^d Public sector workers are included here since they were not distinguished in the source.

■ TABLE 4A.5 Mean Earnings by Occupational Categories, circa 1990 and circa 2002: Selected Countries <i>Multiples of the respective national poverty lines</i>												
Country/ Year	Paid workers						Independent workers and unpaid family helpers					
	Private sector											
	Nonprofessional and technical											
	Total	Employers	Total	Public sector	Total	Professional and technical	Establishment of >5 workers	Establishment of up to 5 workers	Domestic service	Total	Nonprofessional, technical	
Argentina												
1990	6.4	20.6	4.7	—	4.7	9.4	4.5	3.6	2.5	7.9	7.2	
2002	4.7	20.9	3.5	3.3	3.5	6.7	3.1	2.1	1.7	5.6	4.1	
Bolivia												
1989	4.2	16.2	3.9	4.1	3.5	7.7	3.5	2.6	1.6	4.1	3.8	
2002	3.2	7.3	4.0	5.2	3.7	7.7	4.0	2.4	2.0	2.0	1.9	
Brazil												
1990	4.7	16.1	4.1	—	—	8.2	3.8	2.6	1.0	3.8	3.4	
2001	4.3	14.8	4.1	6.7	3.5	6.9	3.1	2.1	1.4	3.2	2.8	
Chile												
1990	4.7	2.5	3.8	—	—	7.4	3.5	2.4	1.4	5.4	5.0	
2003	7.3	4.1	5.7	7.7	5.3	12.3	4.0	2.9	2.4	7.8	5.8	
Colombia												
1991	2.9	7.4	2.7	3.9	2.5	5.3	—	—	1.3	2.4	2.2	
2002	3.0	7.2	3.6	6.4	3.1	6.3	—	—	1.7	1.8	1.5	

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■ **TABLE 4A.6** Relative Earnings by Educational Level, Selected Years in the 1990s: Selected Countries

Country and year	University graduates/Persons with 7–9 years of education	Persons with 16 and over years of education/Persons with 0–3 years of education
Argentina		
1991	2.18	—
1997	2.28	2.74
Bolivia		
1989	2.52	3.36
1996	5.06	4.70
Brazil		
1992	5.53	8.60
1997	5.53	9.44
Chile		
1990	3.66	3.98
1996	4.49	4.52
Colombia		
1988	2.77	2.65
1995	3.27	4.32
Costa Rica		
1990	3.23	4.34
1996	3.17	4.69
Mexico		
1991	1.60	1.71
1997	3.02	2.51 ^a
Peru		
1991	3.21	3.71
1997	4.03	5.25
Latin America ^b		
First year	3.67	5.36
Second year	4.21	6.12

Source: Weller (2000).

Note: — = data not available.

^a Persons of 13 years and more.

^b Country figures weighted by population of 1995.

■ **TABLE 4A.7** Percentage of Wage and Salary Workers with Employment Contracts, by Gender and Type of Establishment, Selected Years: Chile, Mexico, and Peru

Country and year	Public sector	Large private establishments	Small private establishments	Total
Chile 1996				
both	93.7	82.7	53.2	77.5
males	94.0	82.5	53.2	79.2
females	93.4	83.2	54.8	74.7
Mexico 2000				
both	92.3	64.7	10.4	53.3
males	91.9	62.2	9.1	49.4
females	92.8	70.7	13.7	61.6
Peru 2000				
both	52.4	24.3	6.6	25.9
males	52.3	25.8	5.8	26.0
females	52.6	20.4	7.9	25.7

Source: ILO (2003).

■ **TABLE 4A.8 Percentage of Active Workers with Retirement and Pension Coverage (through Contributions), by Vulnerability of Job Category: Selected Years and Countries**

Country/ Year	Low vulnerability		High vulnerability			Total	
	Employers	Paid workers, large establishment	Paid workers, public sector	Independent professionals	Paid workers, small establishment	Independent workers, nonprofessional	Total
Argentina 1992	—	84.7	94.4	—	34.6	—	70.7
2001	—	76.4	85.4	—	24.7	—	63.0
Bolivia 2002	4.8	25.2	68.5	15.1	3.7	1.1	10.8
Brazil 2001	60.0	82.7	91.8	42.2	51.8	16.1	63.9
Chile 2000	55.8	82.7	91.8	42.2	51.8	16.1	63.9
Ecuador 1998	—	42.4	90.0	—	10.6	—	43.5
Mexico 2000	—	58.7	75.4	—	12.1	—	47.6
Nicaragua 2001	4.0	43.7	78.5	4.2	6.0	0.8	19.7
Peru 2000	10.1	31.5	58.1	8.3	3.8	1.3	13.7

Source: ILO (2003) using household survey microdata files from the countries.

Note: Figures for "total" are likely to be seriously inaccurate for those countries for which not all categories are reported; absence of data for certain groups suggests that averages were calculated without taking those categories into account and are hence biased upward. This problem probably affects the figures for "urban" and "rural" to a somewhat lesser extent. The figures for Ecuador seem to be particularly suspicious. — = data not available.

■ **TABLE 4A.9 Average Years of Education of People Aged 25–49, Urban and Rural: Selected Countries**

Country	1980	1981	1989	1990	1991	1999	2000	2001	2002	2003
Argentina										
Urban ^a	7.4			8.8		10.2			10.5	
Bolivia										
Urban			8.8						9.2	
Rural									4.0	
Brazil										
Urban	5.1 ^b			6.2					7.3	
Rural	2.4 ^b			2.6					3.4	
Chile										
Urban				9.7						11.1
Rural				5.5						7.3
Colombia										
Urban	6.8 ^c				8.1				9.3	
Rural					4.1				5.1	
Costa Rica										
Urban		7.5		9.6					9.4	
Rural		4.6		6.3					6.5	
Ecuador										
Urban				8.9					10.1	
Mexico										
Urban									9.1	
Rural									5.3	
Peru										
Urban									10.4	
Rural									5.4	
Venezuela										
Urban		6.8		8.2						8.6
Rural		3.1		4.0						

Sources: ECLAC (2004a, 2004b).

Note: Since the data in the table come from household surveys, they are subject to some degree of error due to noncompatibilities across surveys and other sources of reporting error. It seems highly implausible that average urban education would have fallen in Costa Rica between 1990 and 2002. The source, which includes data for years other than those included here, does show some year-to-year fluctuations that are unlikely to correspond to reality. Blank spaces in table indicate lack of available data.

^a Greater Buenos Aires.

^b 1979.

^c In 1980 the sample covered about half the urban population, whereas the 1991 and 2002 figures covered all or nearly all of it. This implies that the variable probably grew somewhat faster over 1980–91 than the data shown imply.

■ **TABLE 4A.10** Indicators of National and Urban Income Inequality, 1990–2003: Selected Countries

Country	National		Urban	
	Gini coefficient	Theil coefficient	Gini coefficient	Theil coefficient
Argentina ^a				
1990			0.501	0.555
1997			0.530	0.601
1999			0.542	0.681
2002			0.590	0.742
Bolivia				
1989			0.538	0.574
1997			0.531	0.573
1999			0.504	0.487
2002			0.554	0.633
Brazil				
1990	0.627	0.816	0.606	0.748
1996	0.638	0.871	0.620	0.815
1999	0.640	0.914	0.625	0.865
2001	0.639	0.914	0.628	0.875
Chile				
1990	0.554	0.644	0.542	0.600
1996	0.553	0.630	0.544	0.604
2000	0.559	0.666	0.553	0.643
2003	0.550	0.668	0.546	0.641
Colombia				
1994	0.601	0.794	0.579	0.747
1997	0.569	0.857	0.577	0.714
1999	0.572	0.734	0.564	0.707
2002			0.575	0.714
Costa Rica				
1990	0.438	0.328	0.419	0.295
1997	0.450	0.356	0.429	0.323
1999	0.473	0.395	0.454	0.356
2002	0.488	0.440	0.465	0.398
Ecuador				
1990			0.461	0.403
1997			0.469	0.409
1999			0.521	0.567
2002			0.513	0.563
El Salvador				
1995	0.507	0.502	0.466	0.428
1997	0.510	0.512	0.467	0.428
1999	0.518	0.496	0.462	0.388
2002	0.525	0.528	0.477	0.435

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■ **TABLE 4A.10** Indicators of National and Urban Income Inequality, 1990–2003: Selected Countries *(continued)*

Country	National		Urban	
	Gini coefficient	Theil coefficient	Gini coefficient	Theil coefficient
Mexico				
1989	0.536	0.680	0.531	0.678
1994	0.539	0.606	0.512	0.544
2000	0.542	0.603	0.493	0.500
2002	0.514	0.521	0.477	0.444
Peru				
1997	0.532	0.567	0.473	0.453
1999	0.545	0.599	0.498	0.499
2001	0.525	0.556	0.477	0.465
Venezuela				
1990	0.471	0.416	0.464	0.403
1997	0.507	0.508		
1999	0.498	0.464		
2002	0.500	0.446		

Sources: ECLAC (2004a, 2004b).

Note: Blank spaces in table indicate lack of available data.

^a Greater Buenos Aires.

APPENDIX 4.2

Methodological Issues Involved in Attempting to Determine the Effects of Increased Integration and Economic Reforms on Growth, Employment, Distribution, and Poverty

The studies reviewed here shed light on the impacts of economic integration in Latin America using a variety of different approaches. Apart from their quality (as determined by reliability of the data, validity of econometric specifications, and so on), several distinctions related to approach are worth noting at the outset. Others are mentioned in the course of the discussion below.

Which countries? Studies that shed light on the impacts of economic integration on Latin American countries include analyses of specific countries, cross-country analyses of the region, and more general analyses that include Latin American countries among others. Each type of study can make a different sort of contribution to understanding the issues for Latin America.

Analyses using “reform indices” versus others. A number of studies of Latin America have analyzed the impacts of the various reforms, including those in trade and capital markets, using quantitative indicators of the extent of each reform as independent variables to test their effects on outcomes.

Surveys. Some studies are secondary—that is, they review and critique primary studies.

Focus mainly on the effects of economic integration or on the causes of observed economic performance (growth, employment, distribution). Whether a study’s primary concern is to understand the various effects of economic integration or, alternatively, to understand why the regional economy performed as it did over a certain period, it is necessary in principle to take account of all the factors that might have played a significant role in determining outcomes. At the limit, therefore, it may not matter which way the analyst phrases the research question. Normally, however, it does. For example, while an analyst interested in explaining performance distinguishes periods according to the ups and downs of the outcome variables and tries to find differences between

them in the possible causal mechanisms, an analyst interested in the impacts of a certain policy or phenomenon chooses periods between which that policy or phenomenon changed.

Focus on end results (growth, employment, distribution) or on mechanisms. As regards the impacts of trade liberalization and economic integration, both optimists and pessimists base their expectations on beliefs about how economies (and polities–cum–administrative systems) work. Ex post evaluations of performance can thus focus on whether the outcomes themselves corresponded to expectations, taking due account of other factors expected to influence economic performance, or on whether the mechanisms through which the positive or negative effects were presumed to flow could be shown to be working as expected. Thus if freer trade should have raised wages by increasing labor demand in the export sector more than it fell in other sectors, this can be checked either by verifying that wages did rise or by verifying that there was a sectoral shift in the composition of the labor force in favor of exports. The degree of detail with which some mechanisms can be checked is naturally limited by the available data.

Direct evidence on employment impacts or indirect evidence through data on income distribution? For reasons noted above, it is usually easier to learn about changing patterns in the demand for labor and its remuneration through data on income distribution than through the direct evidence on rates of employment, participation, unemployment, underemployment, wages, and so forth. Such direct evidence tends to be partial and the implications of changes in these variables are hard to draw out in the absence of income data. The income data have the advantage of reflecting most of the relevant impacts.

Assumptions made about complementary policies. The success of any policy package depends on whether its elements are consistent with each other and whether other policies, which may not be seen as part of the package or institutionally administered together with the package, are managed in a way that contributes to overall success. Some analyses assume “the best” in terms of management of other policies as they evaluate the implications of any given policy change; others make unrealistic assumptions. Thus most analyses of trade policy changes do not take account of the fact that capital account liberalization will modify the setting for trade liberalization, often

in damaging ways. The discussions of the sequencing of reforms involve this need to keep various policy areas in mind simultaneously.

Completeness of framework: Consideration of other than traditional economic variables. Neither GDP growth nor income distribution data used in most analyses take account of many other possibly important determinants of human welfare. Beyond such areas as education and health, little attention has been paid, at least by economists, to other “social” aspects of development. As a result, the economics-centered debates have not included concerns about certain societal trends related to human welfare and their possible links to the style of growth and development. One obvious omission is environmental impacts, a widely debated matter in the context of policy reforms. Another is changing patterns of labor market insertion; people’s jobs have become less permanent in recent decades, with presumed negative welfare effects that are not allowed for in the GDP measurements (see Osberg, 1998). Rightly or (more likely) wrongly, making labor markets more flexible is often seen as necessary to compete internationally under the new conditions.⁸¹ The conquest of less developed countries’ markets by foreign brands, tastes, and lifestyles is highly controversial, on which it is easy enough to make negative judgments from the perspective of those countries’ welfare. In effect, critics are arguing that GDP as it is now measured is an inadequate and biased indicator of human welfare. While the numbers indicate that national income rises as gambling casinos are introduced into countries that previously lacked them, a case could be made that exactly the opposite is the case. Liberalization involves the introduction of many foreign products into different indigenous settings. Traditional GDP accounting assumes that whatever sells is good. In all respects such as these, the economic literature on trade reforms and economic integration tends to be very narrow and intellectually vulnerable.

⁸¹ See Krugman (1996).

APPENDIX 4.3

Labor Policies in a Context of Increasing Openness

Reforms to make the labor market more flexible, raise formal sector employment, and improve overall labor allocation have been widely touted by the IFIs and others in recent decades. Their desirability and appropriate design is a matter of general import, regardless of trade and capital markets policy. But the issue has been plausibly argued to be more important the more open an economy; overall flexibility would seem to be more important to survival and prosperity under those conditions. Unfortunately, persuasive empirical evidence on the effects of the various elements of labor legislation (minimum wages, firing costs, nonwage costs, and so on) is hard to find. Few attempts have been made to quantify the effects of such legislation and the task is difficult.

The degree of labor market intervention,⁸² and the fact that the urban informal sector in Latin America is large and has grown rapidly since at least 1980, partly explain the amount of attention given in the region to informality, labor market segmentation, and labor market issues more generally. It is clear that the degree of segmentation has often been exaggerated. Not only do most earnings functions show moderate differentials of 25–40 percent between informal and formal sector workers after differences in education, experience, and other relevant variables are taken into account but, as Maloney (1998, 2004) and others have pointed out, there is a substantial voluntary flow of people from the formal to the informal sector, as well as in the opposite direction. This is part of the considerable labor mobility that is especially evident among younger workers and those at a stage of their careers at which they may, for example, wish to start their own small business.⁸³ In his study of the Mexican labor market, Maloney (1998) saw little evidence of the rigidities that the incentives implicit in the labor code would lead one to expect, and certainly no evidence that people wanted to stay in the formal sector until retirement. At least two-thirds of those moving to the

⁸² Riveros (1989) reports, for example, that nonwage costs have typically added 60–80 percent to basic wage costs in Latin American countries, while the comparable ratio for Asian countries has been 20–30 percent.

⁸³ Extensive data on labor mobility are presented by the Inter-American Development Bank (IDB, 2004: Chapter 2).

informal sector did so voluntarily, their main motivations being a desire for greater independence or higher pay. He argued that the very legislation that is thought to induce rigidities into the labor market might in fact stimulate turnover and encourage workers to leave salaried formal sector employment. In a rare attempt to probe different aspects of flexibility related to the labor input, Romaguera and others (1997: 46) distinguish flexibility in the wages, employment, and tasks that a given worker can be assigned, reporting that “the biggest source of rigidity seen among firms in the industrial sector is found neither in the legislation nor in the labor market, but rather in backwardness in the areas of administration and human resource planning inside each firm.” Such a conclusion underlines the fact that too little research has been directed to determining exactly how labor legislation affects firms and how they respond to it.

Judging by the bulk of the empirical analysis to date, it seems unlikely that in the typical country a point of time reallocation of labor among the formal, urban informal, and rural sectors could raise GDP by a significant amount—say, 5 percent of GDP. Given their effect on the wages of their members (typically, an increase of 5–10 percent), unions similarly tend to create only a modest wage distortion (IDB, 2004: Overview). The real question is whether the various imperfections significantly affect investment and technology choice, and hence economic growth and income distribution. Labor institutions (especially unions) have been blamed for slow long-run growth in Argentina, and for impeding adjustment and labor mobility in Brazil and other countries, thus contributing to the painful nature of the 1980s recession and the resulting high levels of unemployment (Horton and others, 1994: 39). It has often been suggested (for example, Birdsall and Sabot, 1997) that the lesser degree of protection/intervention in favor of formal sector workers in East Asia relative to Latin America contributed to the former countries’ superior growth performance, rapid labor absorption, and lower levels of inequality. But many other factors may have helped to create these differences. Latin America’s highly regulated (at least *de jure*) labor regimes did not prevent some countries (including most notably Brazil, but also Mexico, Venezuela, and Costa Rica) from achieving high investment rates in the 1960s and/or 1970s, nor the region as a whole from growing fast in the period 1945–80.

If restraints on firing and generally high worker protection do reduce job creation in the protected sector, one would expect to find larger informal

sectors for a given level of development in the affected countries. Pagés's (2004: 73) results suggest that this is the case, based on cross-country regressions for Latin American and Organisation for Economic Co-operation and Development (OECD) countries. Maloney (2004: 1170) comes up with a different result. Neither of these conflicting conclusions is definitive, among other reasons because only a few developing countries from other regions are included in the sample (those that are members of OECD).

Though the informal-formal earnings gap in Latin America has tended to widen since 1990 and the share of employment in the informal sector increased (at least until 1995), it seems unlikely that these trends are attributable in any significant degree to increasingly damaging labor market imperfections, given the general (albeit mixed—see Saavedra, 2003: 219) trend toward a loosening of the regulatory apparatus. Still, if labor markets need to be more flexible under more liberalized conditions, they may not have moved in this direction fast enough to accommodate the changing needs. Traditionally, shocks have been absorbed through high wage volatility, with inflation and low enforcement of labor legislation pushing the adjustment more to wages than to the level of employment. But recently unemployment has responded more sharply to macroeconomic problems, as inflation rates have been reined in (IDB, 2004: Overview).

Ros (2005) addresses the question of whether labor market imperfections can be held accountable for the numerous increases in open unemployment observed in the region between 1990 and 2002; that rate rose by anywhere from 2.8 to 12.3 percent in most of the larger countries. The exceptions were Mexico (where there was no increase) and Peru and Chile (just a little over 1 percent increase). At the same time, the share of formal sector employment in total nonagricultural employment was in most cases tending downward. Dividing the countries of the region into two groups according to changes in the unemployment rate, Ros notes that in countries where unemployment fell or rose by less than 1.5 percent, growth was faster, investment was higher, there was less exchange-rate appreciation,⁸⁴ and manufacturing exports were more important and growing faster. In a number of the other countries (especially Mexico and Central America), labor-intensive manufacturers predominate and account for an increasing share of exports

⁸⁴ Unemployment tracked the real exchange rate especially closely in Argentina (1989–2002) and rather closely in Uruguay and Colombia (Ros, 2005: 17–18).

(Ros, 2005). A regression to explain the average level of unemployment over 1990–2002 using available indicators of labor market regulation (union power, rate of union membership, job security, and amount of the minimum wage relative to the average manufacturing wage), along with unemployment insurance payments, finds this last variable highly significant,⁸⁵ while none of the others are (Ros, 2005: 21). A review of average indicators of labor market rigidity finds the average unemployment rate to be somewhat lower in the highly interventionist regimes. Ros suggests that the failure of the minimum wage to have a detectable effect may be due to its low level—an average of 0.3 in 13 countries compared to a ratio of 0.6–0.7 in OECD countries (Ros, 2005: 23).⁸⁶ He speculates that the failure of job protection legislation to have an apparent effect is consistent with its theoretically ambiguous impact, through offsetting effects. The possible impact of wage taxes would depend on the workers' tendency to resist an offsetting adjustment of wages. Note that this issue may have changing implications as inflation slows in the region.

Although limited in scope (for example, the unemployment data refer to only two years) and in need of follow-up work,⁸⁷ this study (like Palma, 2005) raises the interesting question of the role of deindustrialization in the region's employment and distributional (and perhaps also growth?) problems, while casting some doubt on whether labor institutions have much or anything to do with them. Ros himself interprets the high rates of unemployment as the result of the combination of deindustrialization and slow growth. His analysis, while essentially a first step in the statistical probing of the impact of labor regulations and hence open to probable revision of results in the future, underlines the complexity of the links between those

⁸⁵ Note, however, that this institution is de facto absent in most of the countries included, and therefore the coefficient could be determined by just one or two cases.

⁸⁶ The exception is the Dominican Republic, with a ratio of more than 0.6, but its unemployment rate was a modest 7.4 percent.

⁸⁷ A cross-country regression to explain the level of unemployment finds GDP growth to be highly significant (with the expected negative effect on unemployment), along with growth of the labor force (positive effect) and the real exchange rate (appreciation increasing unemployment). But a presumably more reliable (given the wide differences across countries in the unemployment rate, probably reflecting national idiosyncrasies) regression to explain changes in unemployment finds that growth and investment have the expected signs but are statistically insignificant, while the most significant variable is labor force growth. This has an unexpected sign (it lowers unemployment), which could mean that it is acting as a fixed effect (though Ros has a more complicated interpretation). Industrial exports and the real exchange rate are moderately significant and of the expected sign. Some of the possible anomalies might be clarified by further work.

regulations and labor market outcomes and the paucity of credible evidence on their effects.⁸⁸

The simultaneous achievement of not just narrow static efficiency but also dynamic efficiency in the allocation of labor, together with job security and other aspects of work that matter very much to people, is clearly a major challenge. And labor market performance does appear to have fallen farther short of the ideal in recent decades, because of the combination of greater macroeconomic fluctuations and lower levels of inflation, with the latter reducing the capacity of labor markets to adjust. Still, static misallocation of labor because of labor market imperfections (including bad policies) is unlikely by itself to have very severe efficiency costs. Discouragement of physical and human investment may, but the evidence is unclear as to whether this outcome is frequent or not, since too little is known about how labor market policy affects economic performance within the range of typically observed labor force policies. Given the apparently very large psychological cost of worries about job security, it is arguable that the biggest institutional flaw in Latin America is not the existing regulations but the absence of a system to diminish the cost of job insecurity. Though several countries now have nascent unemployment insurance systems, their coverage remains very limited. A case can also be made that the single biggest failing of many labor markets may take the form of higher inequality due to the incentive toward capital-intensive technologies, as well as of job insecurity.

The impact of labor institutions (including unions) clearly deserves much more research. That research should involve greater integration between labor economics per se and industrial relations, and a much more explicit consideration of exactly what determines worker welfare and what it is about labor markets that affects firm behavior. Nearly all aspects of labor legislation and institutions are based on a valid logic, but they risk producing negative effects when those valid objectives are carried too far or somehow distorted. Unions can bring benefits in the form of job stability, a vehicle for communication with employers, and a way to reconcile interests for society as a whole, or they can generate serious rigidities. It is important to recognize that there

⁸⁸ Further steps to extend this analysis would include (i) introducing the other variables with identified impacts on unemployment into the regression, along with the labor regulations variables; (ii) analysis of year-to-year changes in unemployment, not just those over the whole period studied; (iii) analysis of why some countries are outliers—especially Mexico, with its very low unemployment rates; and (iv) reassessment of the accuracy of the indicators of regulation used.

is no such thing as free labor markets, in the sense of markets unaffected by institutional constraints. As Pagés (2004: 68) notes, “the right approach is not to discuss when or how to deregulate. Instead, the discussion must be based on which set of institutions and regulations will improve the functioning of labor markets and whether the regulations that are already in place achieve their goals or instead need to be amended.”

To summarize, several factors make it difficult to assess the impacts of labor market institutions and policy. First, the determinants of the key variables to be explained—investment and technological change—are poorly understood in general, making it hard to determine which effects are specific to labor policy and labor market functioning. Second, the partial and selective application of labor legislation greatly complicates any statistical analysis, since the degree of implementation of laws is hard to measure. Finally, the new and more open context of today may differ enough from the previous one that analysis should not mix results from the two settings.

Cautious pursuit of labor market reforms in Latin America and the Caribbean is probably desirable, since there is a *prima facie* case that some elements of labor legislation may sufficiently discourage employment as to have an overall negative impact on the labor force. But it must also be accepted that almost any sort of reform would have unpredictable effects, since analysts simply do not understand the relevant reality well enough to make reliable predictions. To begin with, it is true in LAC, as in most of the developing world, that most new jobs are created either in microenterprises, which labor legislation does not reach, or in SMEs, about whose *de facto* (as opposed to *de jure*) interface with that legislation we know woefully little. Studies of the dynamics of SMEs (for example, Cortes and others, 1987) make it clear that such firms are often able to circumvent important aspects of labor legislation, often with the connivance of the workers when it is in their joint interest to do so. Another powerful ground for caution lies in our defective understanding of institutional dynamics in general; hence the implausibility of arguing that if a set of institutions are changed to make them more like those in another part of the world, outcomes will also change to match those in that other part of the world. Path dependency appears to be important in many aspects of economic change, and thus is likely to be in this one.

5

The Social Impact of Regional Integration in Rural Latin America

Alexander Schejtman and Julio A. Berdegue

Have the economic liberalization and global integration of Latin America's economies generated growth and social welfare in the rural sector? Since the mid-1980s, the causal association of these factors has been an axiom of public policymaking in the region. This chapter addresses the issue. Sections 5.1 and 5.2 seek to describe the region's foreign trade patterns and trends in inequality and poverty, and conclude with an assessment of the past decade's changes in connections among liberalization, growth, inequality, and poverty. Section 5.3 considers whether the models designed to express the relations of these variables adequately account for past events and can serve as a basis for designing inclusive strategies, or whether a new approach is needed. Section 5.4 formulates guidelines for a rural development strategy based on the simple model developed at the end of section 5.3.

After two decades of experience, the available evidence does not support the universal validity of the axiom. In Latin America, economic liberalization and integration have not always translated into higher growth rates, nor have higher growth rates, when present, necessarily led to improved welfare in the countryside. Nonetheless, the argument that less liberalization allows for greater growth and improved welfare in rural sectors is also unsustainable. Globalization champions and critics alike base their positions more on ideology than on healthy empirical foundations. Models under which "liberalization + integration = growth that produces rural welfare" are a very precarious foundation on which to design public policy. More rigorous studies based on solid empirical evidence are needed to reach conclusions on the relationships of liberalization and integration, growth, and welfare in the rural sector. The hypothesis proposed here is that these relationships should be measured in the context of the mediating factors specific to each country. In the absence of a solid theory, strategies leading to more inclusive

trade-integration processes must be based on an approach for undertaking national and local descriptive studies that elucidate how liberalization positively or negatively affects the most vulnerable sectors in each society.

5.1 Regional Integration

The history of integration agreements in Latin America dates back 40 years. The 1960 Central American Common Market (CACM) was the first initiative; the Andean Community followed in 1969, and the Caribbean Community (CARICOM) in 1971. Founded on the substitutive industrialization model, these agreements created major barriers to trade with third parties, formed exclusively by South-South relationships, and had neither radical effects on production structures nor strong enforcement mechanisms.

The New Regionalism and the Proliferation of Integration Agreements

As of the 1990s, integration agreements were part of the structural reform process. They included a high degree of liberalization of trade with third-party countries, driven by unilateral tariff reductions that lowered the region's average tariffs from more than 40 percent in the mid-1980s to 13 percent less than 10 years later. The accelerated growth of South-South and North-South exchanges¹ has significantly influenced the transformation of the production structure of the countries involved. Those countries have now accepted clearer rules, including those derived from the World Trade Organization, with more explicit arbitration mechanisms. The Economic Commission for Latin America and the Caribbean (ECLAC) distinguishes these integration efforts from previous ones and refers to the process as "open regionalism."

This new regionalism is based on expectations of obtaining access to sources of capital and inputs that are unavailable at comparable costs in the domestic market. The use of external savings as a supplementary source for financing investment would make foreign currency reserves and the technological advances required for improving competitiveness available. These benefits

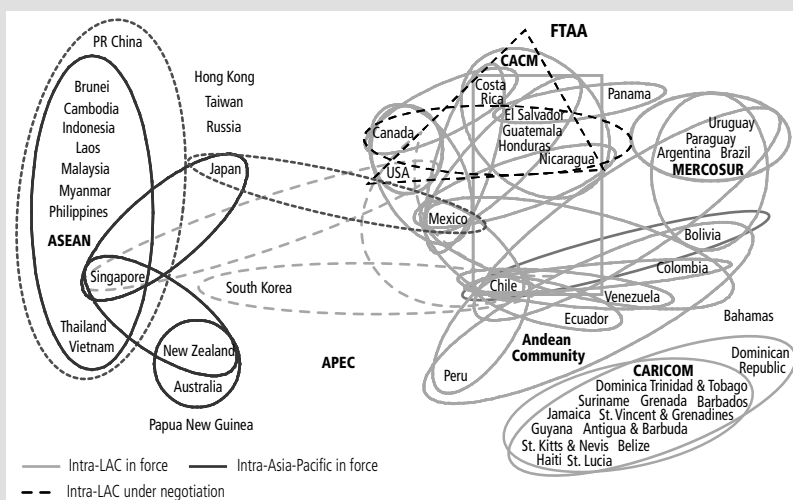
¹ For the Americas as a whole, the proportion of hemispheric exports rose from 48 percent to nearly 60 percent in 2000. The same phenomenon is evident in subregional integration agreements. When the Southern Common Market was created, it covered only 9 percent of total exports traded among the member countries. By the end of the 1990s, it covered 25 percent.

would translate into accelerated growth, thereby reducing poverty and, eventually, overcoming inequalities in the distribution of income.

Together with the acceleration of trade, regional integration agreements have proliferated and have supplanted the more generic trends of the globalization process since the early 1990s. They include the creation of the Southern Common Market (MERCOSUR); the North American Free Trade Agreement (NAFTA); the Costa Rica–Mexico agreement; the G-3 (Colombia, Mexico, and Venezuela); the Bolivia–Mexico, Canada–Chile, Mexico–Nicaragua, Chile–Mexico, and Mexico–Central America agreements; the Northern Triangle (Mexico, El Salvador, Guatemala, and Honduras); the Chile–U.S. and Mexico–Uruguay agreements; the agreement between MERCOSUR and the Andean Community; the agreements concluded by Mexico and Chile with the European Union (EU) and with South Korea; and so on. In addition, a number of negotiations are well advanced: the United States and the region’s countries aim to create the Free Trade Area of the Americas (FTAA); a Chile–India agreement is in progress.

The multiplicity of agreements has created a virtual maze or “spaghetti bowl” (figure 5.1). It has also made it difficult to assess the impact of each individual agreement, particularly its social impacts, as opposed to greater

■ FIGURE 5.1 The Complex Web of Trade Agreements



Source: Mitsuyo, Estevadeordal, and Miller (2002).

■ **TABLE 5.1 Agreement Coverage and Schedules for Tariff Elimination**

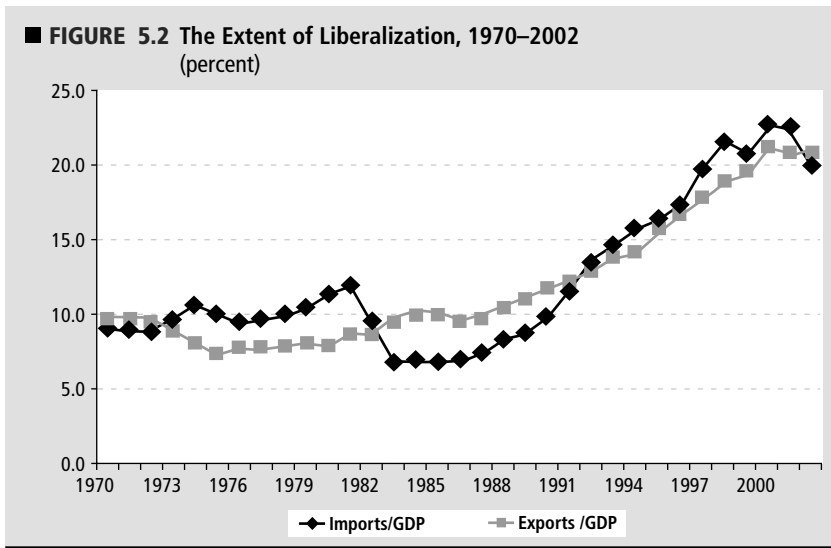
Few or no products excluded	Chile–United States Chile–Mexico G-3 (Mexico–Colombia–Venezuela)	North American Free Trade Agreement Mexico–Nicaragua Central American Free Trade Agreement—Dominican Republic Chile–South Korea
Many products excluded	Israel–Mexico European Free Trade Association—Mexico Chile–EFTA	Costa Rica–Mexico Bolivia–Mexico Canada–Chile Central America–Dominican Republic Central America–Chile Mexico–Northern Triangle (El Salvador–Guatemala–Honduras) Canada–Costa Rica Mexico–European Union Chile–European Union
	Liberalization in the short term for many products	Liberalization in the intermediate to long term for many products

Source: Kj  llerstr  m (2005).

or lesser increases in trade for certain products. The difficulties involved in estimating the impact of each integration agreement are further complicated by the differences in the agreements with respect to agriculture: included and excluded products, time frames for their liberalization, scope of coverage, and schedules for the elimination of tariffs (table 5.1). The issues discussed below, therefore, can refer to only the effects of liberalization in general, without determining which integration agreements are responsible for which effects. This is the context for the changing patterns of trade among the region’s countries and the rest of the world—with their effects on rates of employment, availability of job types, and income.

Liberalization and Patterns of Entry into Global Markets

Most of the region’s countries have opted to make exports one, if not the main, driving force behind the growth of their economies. This is evident in the increasing extent of liberalization starting in the 1990s (figure 5.2). Hence, both the dynamics and the composition of the types of products subject to trade need to be examined, since both will influence the social impact of integration agreements.

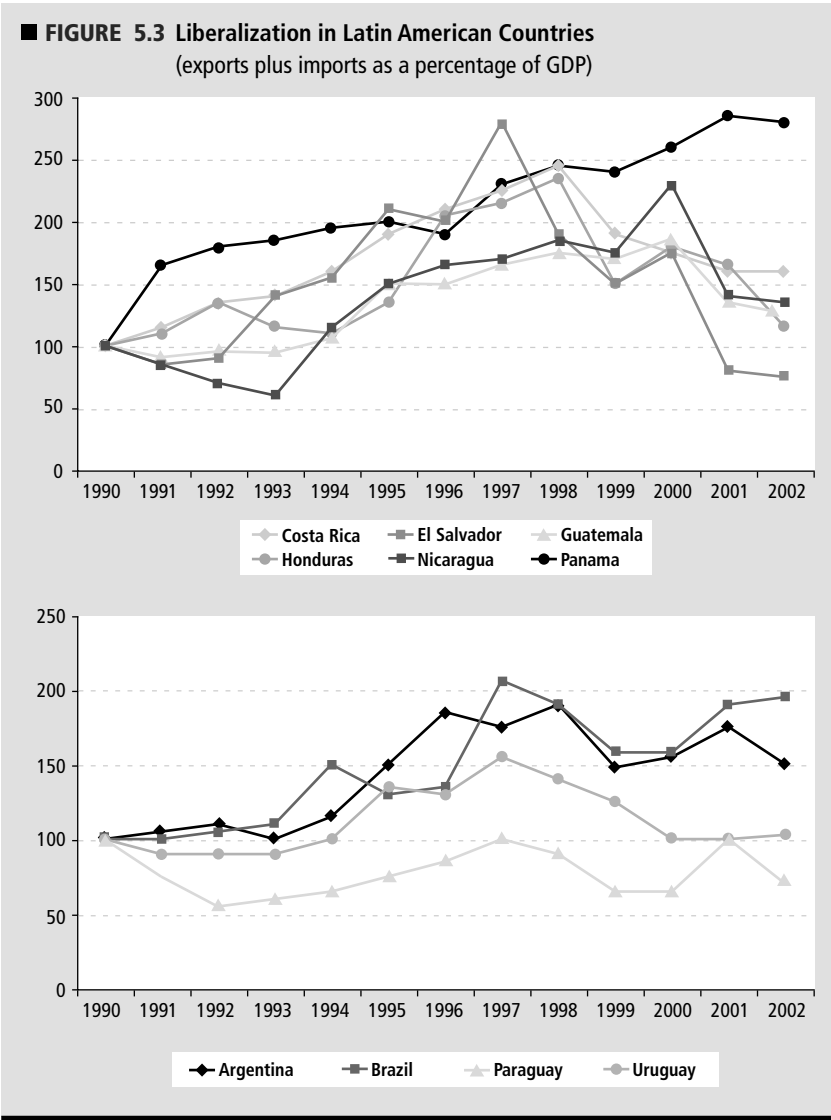


Source: Based on ECLAC data.

Taking the ratio of exports plus imports to the gross domestic product (GDP) as a measure, the extent of liberalization varies significantly from country to country (figure 5.3). A first group, comprising Argentina, Brazil, Colombia, and Peru, reveals a comparatively low degree of liberalization (approximately 30 percent) that has, however, tended to grow in recent years. By contrast, the Central American countries have been characterized over the past two decades by high degrees of liberalization, which in some years has surpassed 80 percent (Costa Rica).

Well into the 1990s, Mexico maintained a relatively low level of liberalization (about 25 percent, similar to the rate for Brazil and Argentina). It took a leap in the mid-1990s with the surge of free trade agreements (FTAs), and in recent years liberalization has increased by about 55 percent. Chile, after a period of decline, regained its late 1980s levels of extensive liberalization as a result of its FTAs with Canada and the United States (figure 5.3). In general, the trend in most countries has been toward increased liberalization starting in the 1990s, the result of tariff reductions, and an emphasis on exports as the driving force of the economy.

For the purposes of characterizing patterns of market entry, if global trade is classified by the degree of technological content, there are significant differences in growth rates among the different categories: primary products, products

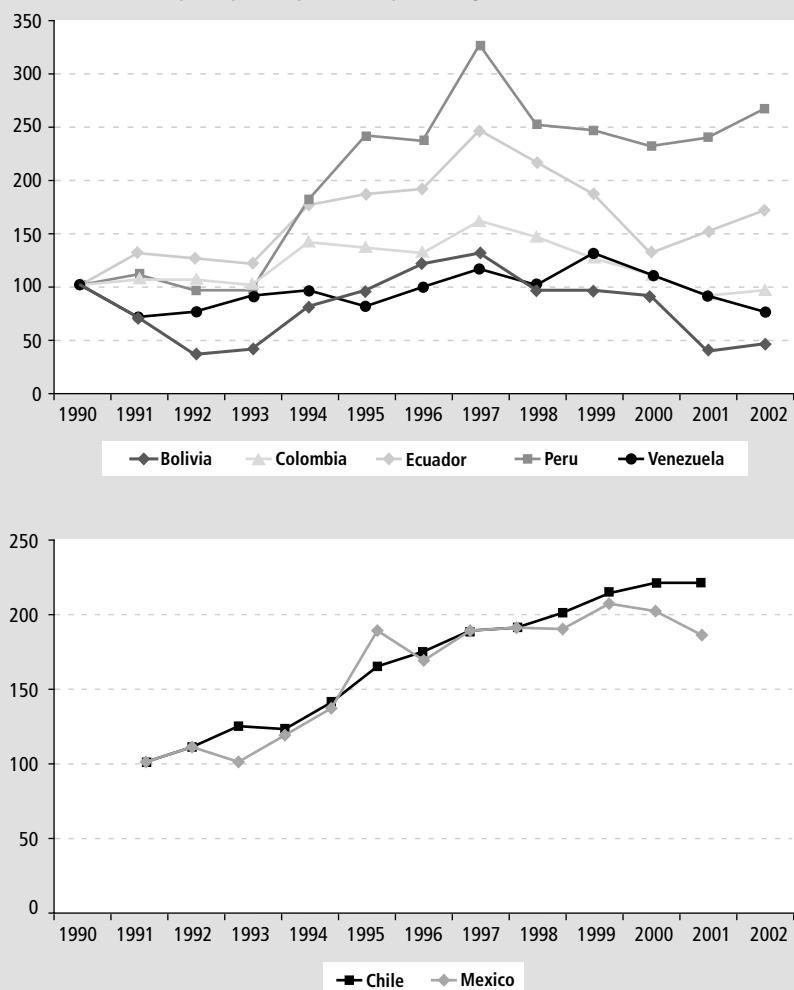


Source: Based on ECLAC (2002).

Continued on next page

manufactured directly from natural resources (including processed foods, wood products, and energy-mineral products), manufactured products not based on natural resources but technologically “mature” (mainly textiles, clothing, and iron and steel products), and products not based on natural resources but technologically new. At a global level, primary products are growing at an accrued

■ **FIGURE 5.3 Liberalization in Latin American Countries** (*continued*)
(exports plus imports as a percentage of GDP)



Source: Based on ECLAC (2002).

annual rate of 1.6 percent, manufactured products based on natural resources at 3 percent, mature products at 6.8 percent, and manufactured products that are new or have increased technological content at 8.1 percent.

Under these circumstances, the long-term dynamics of global market entry for the region's countries appear to be associated with the relative weight of

the various types of goods within its export mix and the speed at which that composition is moving toward more dynamic lines of goods.

A comparison of the structure of exports from Latin America, using the average for the period 1985–7 as a baseline for the 1999–2001 period, indicates that exports have moved in a positive direction. There has been a trend toward a lower relative presence of primary products and toward growth in manufactured goods not based on natural resources, particularly intermediate- and high-technology goods (table 5.2). Nonetheless, this transformation has been significantly slower than in China and the countries of Southeast Asia. It has been especially weak in the Andean Community and Central American countries, with the exception of Costa Rica, which accounts for all of the increase in Central America.

Primary products and manufactured goods based on natural resources constitute between 80 percent and 100 percent of exports in the countries where the highest proportions of the rural population live in poverty. Small and medium-sized rural or urban producers produce many of the products in these categories (agricultural products and clothing, for example); most are

■ **TABLE 5.2 Structure of Exports by Categories of Technological Intensity**

	Raw materials		Natural resource-based manufactures		Low-tech manufactures		Medium-tech manufactures		High-tech manufactures	
	1985–1987	1999–2001	1985–1987	1999–2001	1985–1987	1999–2001	1985–1987	1999–2001	1985–1987	1999–2001
Latin America and the Caribbean	49.4	27.3	24.5	17.5	9.0	12.2	13.6	26.1	3.4	18.9
Southern Common Market	39.0	33.7	23.8	24.7	14.7	11.3	19.1	21.7	3.5	8.6
Brazil	34.3	26.3	23.9	25.6	15.2	11.9	22.6	24.6	4.1	11.6
Andean Community	60.6	58.8	31.6	26.8	4.6	6.4	3.1	7.0	0.2	1.1
Mexico	52.8	11.5	12.0	6.1	6.6	15.6	21.5	38.3	7.1	28.5
Central American Common Market	76.4	36.3	9.9	16.1	7.1	15.4	3.7	11.3	3.0	20.9
China	41.7	6.2	13.4	9.9	31.2	41.8	10.8	19.4	3.0	22.7
Indonesia	70.6	33.4	21.5	22.3	5.3	22.3	2.1	11.9	0.5	10.1
Philippines	24.9	3.4	37.4	6.2	19.4	11.7	8.3	10.6	9.9	68.1
Thailand	39.1	12.3	21.8	16.6	23.7	19.4	9.9	20.7	5.5	30.9

Source: Based on ECLAC data.

exported to the developed countries, where they are subjected to the highest levels of tariffs and nontariff measures.

Liberalization and the Agricultural Sector

In this generalized process of liberalization, how has the agricultural sector fared? To analyze the average annual growth rate of production between 1990 and 2000, the three panels of table 5.3 display data for three sets of agricultural products: basic consumer products traditionally earmarked for the domestic market,² traditional export goods, and nontraditional export goods. In the course of liberalizing, some countries (Argentina, Peru, Brazil, and Chile) have increased the production of all three types of products. In other countries, such as Colombia, the stagnation has also affected these three categories.

Some traditional exports, such as cotton, are falling in all of these countries, whereas other products linked to the domestic market, such as milk, are increasing throughout the region. Certain nontraditional lines of exports, such as citrus fruits, have experienced generalized growth. Others, such as soybeans, are increasing in some countries (Brazil and Argentina) but falling sharply in others (Mexico and Colombia).

There are several reasons for these trends. In some cases, the country's international competitiveness stimulates production (for example, soybeans in Brazil and Argentina). In others, lack of competitiveness on the open market triggers declines in production (soybeans in Mexico and Colombia). In still other cases, public policies to encourage production and protect trade do serve to drive production (milk, in several countries of the region). In certain countries where tariffs on a given product were reduced while support programs for the product was dismantled or weakened, the expected fall in production did not occur because the producers responded with greater productivity. The most notable case is corn in Mexico (Yúnez-Naude and Barceinas Paredes, 2002).

Given such varied trends in production, what were the regional trade trends for the principal agricultural products in 1990–2000? Figure 5.4 shows that the regional trade balance increased strongly and steadily for certain export commodities such as oilseed, sugar, fruits, and vegetables. Other traditional exports such as coffee and meat have also tended to rise, with major ups and downs in both cases over the decades.

² Corn and wheat in Argentina are exceptions because they are export commodities.

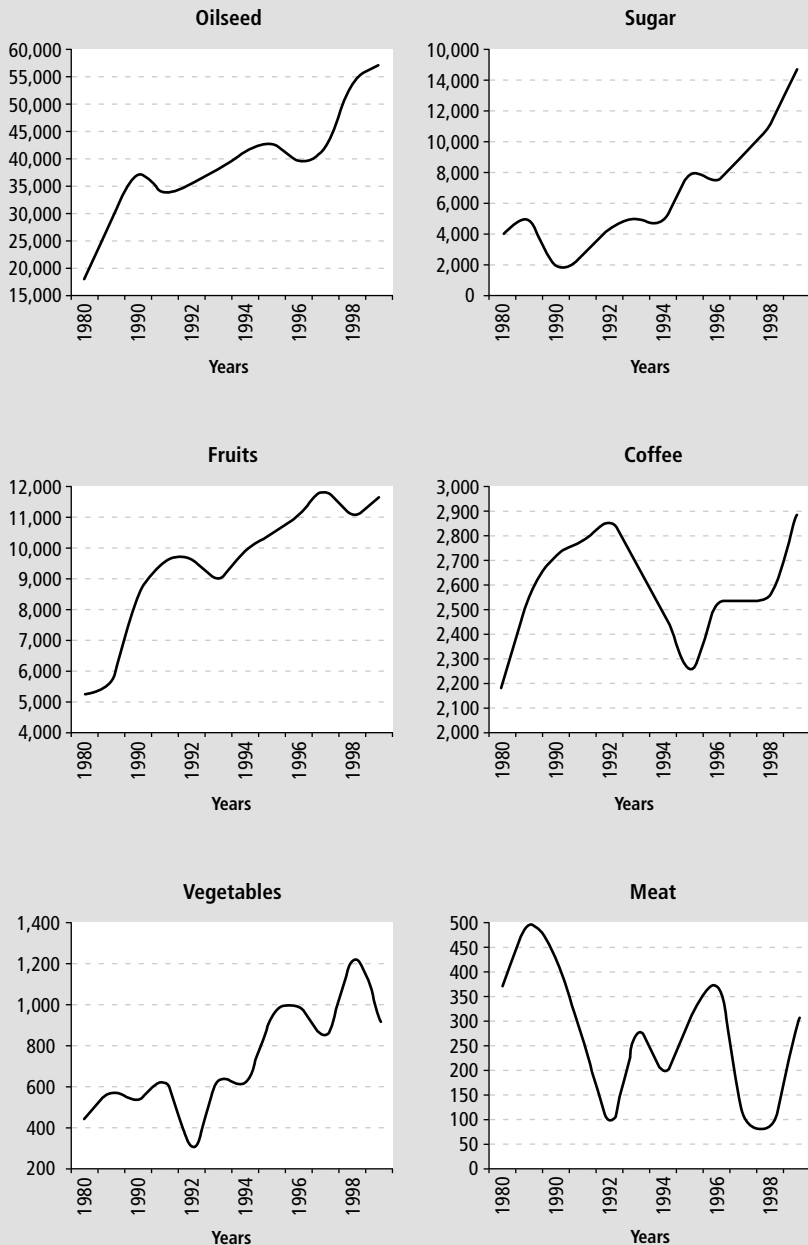
■ **TABLE 5.3** Average Annual Growth Rate of Agricultural Production, 1990–2000

a. Basic products					
	Corn	Vegetables	Roots and tubers	Milk	Wheat
Argentina	10.5	3.7	6.8	4.5	3.2
Brazil	4.3	3.2	−0.8	4.2	−4.3
Mexico	2.5	−1.0	2.0	4.1	−1.3
Chile	−2.4	−7.8	1.8	4.6	−1.3
Peru	7.2	9.1	8.6	3.0	6.4
Colombia	−1.8	−2.6	0.9	3.6	−10.1
Guatemala	−1.4	−1.2	1.0	2.4	−21.1
Nicaragua	2.2	4.8	0.8	3.9	—
Costa Rica	−8.0	−6.8	5.8	3.3	—
b. Traditional exports					
	Bananas	Coffee	Beef	Sugarcane or beet	Cotton
Argentina	−1.4	—	−1.3	2.1	−7.1
Brazil	−0.5	2.3	4.6	1.7	−0.1
Mexico	−1.0	−2.2	2.4	2.1	−3.4
Chile	—	—	0.4	3.7	—
Peru	—	6.7	1.5	1.5	−3.1
Colombia	1.7	−2.9	0.1	2.9	−6.8
Guatemala	4.9	3.8	−3.8	6.0	−33.1
Nicaragua	−1.8	11.3	−1.6	5.3	−22.0
Costa Rica	1.9	0.8	0.1	4.3	−8.1
c. Nontraditional exports					
	Fruits	Vegetables	Soybeans	Citrus fruits	
Argentina	0.9	1.9	6.2	3.9	
Brazil	3.2	−0.8	4.8	2.6	
Mexico	2.2	4.1	−14.9	4.8	
Chile	3.9	3.2	—	0.6	
Peru	4.7	8.0	1.0	6.6	
Colombia	2.8	−1.0	−14.2	12.2	
Guatemala	1.9	0.2	1.7	−0.6	
Nicaragua	0.9	−5.6	7.3	0.7	
Costa Rica	7.9	6.7	—	9.9	

Source: ECLAC and IICA (2002).

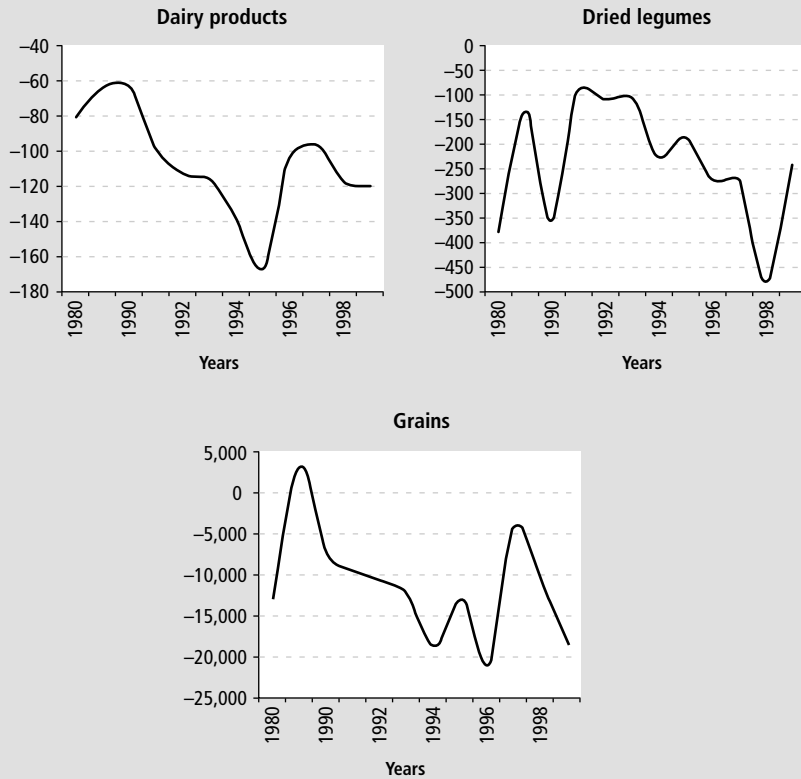
Note: — = data not available.

■ **FIGURE 5.4** Balance of Trade of Selected Agricultural Products, 1990–2000
(thousands of metric tons)



Continued on next page

■ **FIGURE 5.4** Balance of Trade of Selected Agricultural Products, 1990–2000 (*continued*) (thousands of metric tons)



Source: ECLAC and IICA (2002).

In basic consumer goods, the region has become increasingly dependent on imports, a trend that predates liberalization. For dairy products, the deficit increased sharply well into the decade, after which the trade balance improved as a result of support policies, though it still showed a deficit. For grains, dried legumes, and tubers, support policies in several countries successfully stimulated fleeting reductions in the deficit, but the trend in this decade is toward increasing dependence.

In sum, for the region in aggregate, liberalization has simply accentuated preexisting trends in the trade balances for these products. Nonetheless, the trends in agricultural trade under various integration agreements vary

sharply from one agreement to another, and among agreement members. In MERCOSUR, Argentina and Brazil show a clear trend toward growth, particularly as of the second half of the 1990s, with increases in grains, soybeans, oilseed, and meat for Brazil. By contrast, Uruguay has remained stagnant and Paraguay has experienced a decline.

In the Andean Community, Peru's accelerated growth is noteworthy, with export levels 2.5 times higher than in the past decade. Growth has also accelerated in Ecuador, though at a slower pace as exports have doubled. By contrast, Colombia, Venezuela, and Bolivia ended the decade with lower levels of exports than at the beginning, even using current dollars. In the CACM, growth in both El Salvador and Honduras accelerated in the first third of the decade and then declined sharply in the following years; the other countries—with the exception of Panama, which grew during the entire period—show similar but more moderate behaviors.

Among the MERCOSUR countries, agricultural exports do not exceed an average of 20 percent of commodity exports with the exception of Paraguay, which has had the worst performance in the past decade and where agricultural goods represent 60 percent of exports. For the Andean countries, these exports are relevant only in Colombia and Ecuador (average of 30 percent and 42 percent, respectively). In Colombia and Bolivia, these exports declined in the second half of the decade. In the countries of the CACM, with the sole exception of Panama, the share of total commodity exports represented by agricultural exports—which is particularly significant in all these countries except El Salvador—ranges from an average relative weight of 71 percent in Honduras to 48 percent in Costa Rica. In Panama, the average share of agricultural exports is 70 percent and growth has been sustained.

Distortions in International Agricultural Markets

Most of the trade negotiations in the Uruguay Round focused on the industrial sector and on those product categories in which the developed countries had a particular interest. Industry has thus benefited from a sustained process of tariff reduction. By contrast, agriculture and products manufactured from agricultural inputs now have the highest levels of protection.³ Compared with

³ The average tariffs or the equivalents thereof imposed by the developed countries are higher for agricultural products (12 percent to 20 percent in the United States and the EU, respectively) and lower for

any other globally traded category of products, the agriculture sector has the greatest distortions (table 5.4). Reforming trade in agricultural products is at the center of the relationship between trade and poverty.

A recent report from the Organisation for Economic Co-operation and Development (OECD) and cited by *The Economist* (June 22, 2005) notes the limited progress made in liberalizing agriculture over the past two decades. The sum total of public financial support in the OECD countries has fallen a mere 7 percent since 1986 and is currently equivalent to 30 percent of those countries' agricultural revenues.⁴ During the 1990s, this support stabilized at about \$280 billion a year.

The sugar market is one of the most distorted in the world. The EU, the United States, and Japan provide sugar subsidies in excess of \$6.4 billion a year—almost equal to the entire value of sugar exports from developing countries. The elimination of these subsidies would produce annual earnings of \$4.7 billion for Latin America, taking into account the net impacts on producers, consumers, and taxpayers. Global sugar prices would rise by about 38 percent, and production would increase by 20 percent.

Dairy products fall under a complex system of supports and barriers to accessing the markets of the industrialized economies, particularly the EU, the United States, Canada, and Japan. The power of the interests surrounding the dairy industry cast doubt on the possibility of any significant changes from the Doha Round. Tariffs in Europe reached levels of more than 100 percent, and in the United States the 2002 Farm Bill earmarked \$1.6 billion to support the sector. The United States supports meat even more than dairy products.

The subsidy policies and other distortion practices in international foodstuffs trade produced a significant drop in the prices of basic grains and sugar between 1980 and 2000: 40 percent for corn, 37 percent for soybeans, 52 percent for wheat, 59 percent for rice, and 72 percent for sugar.⁵

manufactured goods imported from high-income countries (0.2 percent) than for textiles and clothing (9 percent to 10 percent). Oxfam has estimated that by simply eliminating restrictions on imports of textiles and clothing, up to 27 million jobs could be created, many of which would be filled by women now living below the poverty line. The combined effect of the tariffs and quotas on textiles and clothing imposed by wealthy countries represents export revenue losses of approximately \$40 billion for the developing countries. India alone loses almost \$10 billion on that account.

⁴ Some 20 percent in North America, 35 percent in the EU, and 60 percent in Japan.

⁵ The United States accounts for about 25 percent of total exports of wheat and 12 percent of rice. It has a market share close to 60 percent for the rest of the grains and nearly 47 percent for soybeans.

■ TABLE 5.4 Distortions in Global Markets for Certain Agricultural Products

Product	Principal sources of distortion	Average tariff worldwide	Domestic support	Effect on world prices of eliminating distortions
Cotton	Domestic subsidies. Sporadic support in China. Indirect tax via Agreement on Textiles and Clothing. Reactive support in India, Brazil, Turkey, and Mexico, caused by low prices.	5.2% average, most-favored nation (MFN), 1995–8.	\$5.3 billion worldwide (direct income and price support).	Increase of 10% to 20%.
Dairy products	Tariff-rate quotas (TRQ), with high out-of-quota tariffs, export subsidies, domestic subsidies in Canada, United States, Japan, and the EU. TRQ and domestic support in Korea. Trade barriers in China and India.	29.4% average, MFN, 1995–8.	\$39.4 billion, 2001; \$11.56 billion, average, 1995–8.	Increases of 20% to 40% for milk, cheese, milk powder, casein, dry-whey.
Peanuts and peanut products	Trade distortions in China and India. Redundant tariffs in the United States. Former distortions on peanuts, but much reduced with the Farm Bill of 2002.	12.7% on peanuts, 11.3% on oil, 5.8% on oil cake.	\$0.3 billion, 2002, United States; \$0.35 billion, average, 1995–7.	Increase of 10% to 15% for peanuts, oil, and oil cake.
Rice	Tariffs escalation by milling stage in the EU and the Latin American and Caribbean countries. Prohibitive tariffs in Japan, Korea, and EU. Tariffs in Indonesia and India and many net importing countries outside the Middle East. High tariffs on short- and medium-grain rice, and lower tariffs on high-quality, long-grain rice.	43% for all rice types, 217% for Japonica rice, 21% for Indica rice.	\$20.75 billion, average, 1995–8; \$24.34 billion, 2001.	Increase of 33% on average, but up to 90% for short- and medium-grain rice.
Sugar	High domestic and trade policies in the EU, United States, and Japan. Trade distortions in Turkey and many other countries. Reactive support by competing producers caused by low prices.	26.6% average, 1995–8.	\$5.3 billion, average, 1995–8; \$5.2 billion, 2001.	Increase of 20% to 40%, depending on the modeling approach.

Source: Adapted from Beghin and Aksoy (2003).

An end to such practices would affect the prices of basic foodstuffs in varying ways. The estimated magnitude of these changes also varies significantly, depending on the model and the assumptions. Anderson (2004) estimates that total liberalization of agricultural policies in the OECD countries would increase the price of foodstuffs by only 5 percent in real terms.

Estimates by Brown and Richards (1990) for the United Nations Conference on Trade and Development have indicated that complete liberalization would create the highest price increases in sugar (26.5 percent), rice (42 percent), wheat (20.4 percent), and beef (12.5 percent). Beghin and Aksoy (2003) forecast increases of 20 percent to 40 percent for sugar and dairy products, and 30 percent for rice on average—up to 90 percent for medium-grain selected rice—as a result of the elimination of the main sources of distortion.

As a result of changes in prices and trade volumes, Santos (1992) estimated that a complete liberalization in agriculture of the main foodstuffs mentioned above⁶ would cost the 10 countries of the region export deficits of almost \$250 million, but would generate more than \$500 million in earnings.

Trade and Food Security

The debate over public agricultural trade policies includes the issue of food security. For the purposes of diagnostics and policy setting, it is helpful to analyze the following problems that affect the overall availability of foodstuffs: the sufficiency of domestic supplies to satisfy assumed socially desirable levels of demand and the stability of that supply over time, the degree of autonomy or self-sufficiency (or its inverse, the degree of external dependency), the long-term sustainability of these conditions, and the quality and safety of the foodstuffs. Whatever happens to foreign trade in foodstuffs will directly affect each of these conditions.

A sufficient supply is defined as being able to satisfy both the effective existing demand and the basic food needs of those sectors that cannot translate their needs into market demand because of income problems.⁷ Stability refers to the probability that the food supply will fall below a certain percentage of prevailing consumption or average requirements over a given period.⁸

Degrees of autonomy can also be estimated by several means: the percentage of the Food Energy Supply (FES) ingested, the imported percentage of basic grains in the national diet, or the percentage of foreign-currency

⁶ Corn, wheat, rice, sorghum, beef, and soybeans.

⁷ Sufficient supply has been arbitrarily defined as that which exceeds effective demand by 10 percent.

⁸ Estimated stability uses the variability in consumption over the 1970–2000 period based on changing averages for five-year periods, estimating the probability that the food supply will fall 5 percent below observed levels of availability.

■ **TABLE 5.5 Summary of Indicators of Aggregate Availability of Foodstuffs**

Autonomy	Levels of sufficiency		
	Full	Precarious	Critical
High	Argentina (SS) Brazil (S) Colombia (SS) Paraguay (SS)		
Medium	Chile (S)	Ecuador (U)	
Low	Costa Rica (SS) Cuba (S) Mexico (S) Venezuela (U)	El Salvador (U) Panama (U) Dominican Republic (SS)	Bolivia (SS) Guatemala (S) Haiti (S) Honduras (S) Peru (U) Nicaragua (U)

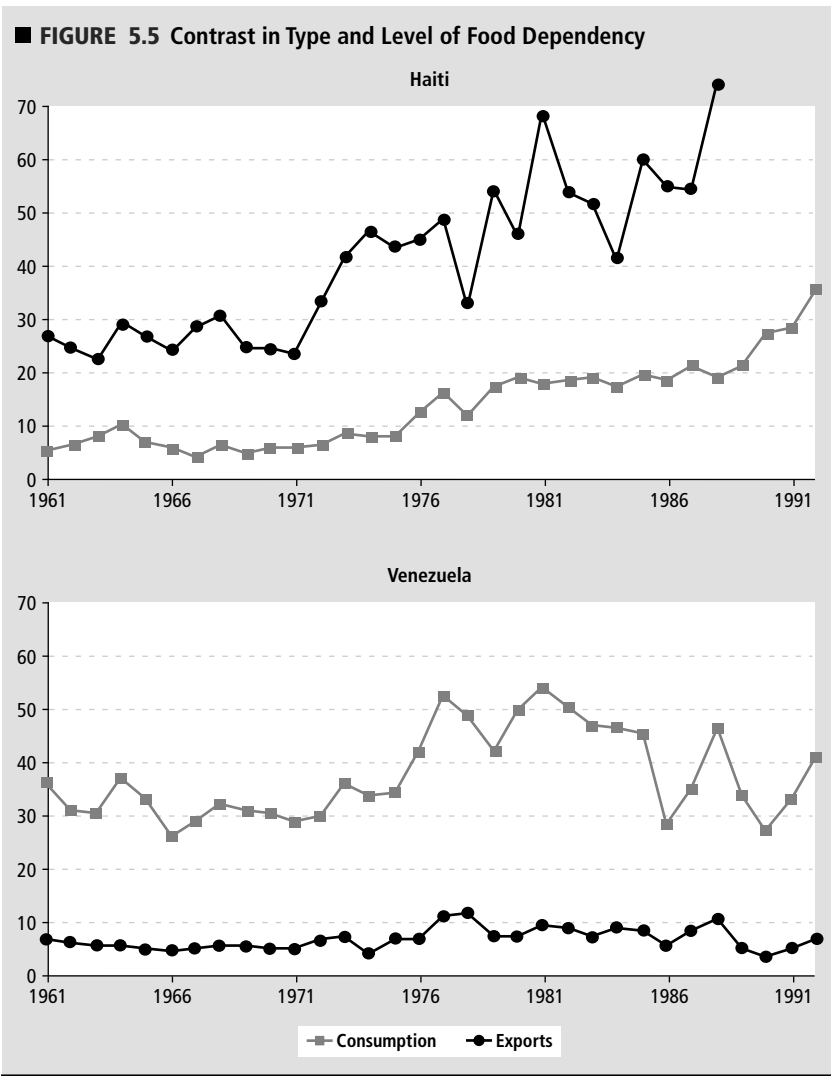
Source: Schejtman (1994).

Note: S = stable, SS = semistable, U = unstable.

reserve income used for importing foodstuffs, since high dependency as indicated by the first two indicators has different implications if the share of foreign-currency income it represents is low.

Table 5.5 summarizes the situation of Latin American countries between 1980 and 2000. As is apparent, only 4 of the 19 countries exhibit a high degree of autonomy and self-sufficiency in addition to a reasonable degree of stability in their food supply. The great majority are net importers of foodstuffs, and in some cases import more than 40 percent of their food intake. Dependency levels for Costa Rica, Mexico, and Venezuela, however, do not have the same significance as for the others, because foodstuffs do not constitute a very significant share of foreign-currency income (figure 5.5).

Without going into greater detail on the trends indicated, studies on changes in consumption patterns in the various countries of the region suggest that dependency levels have grown to some extent from substituting other grains for native or traditional products, for which domestic production conditions and (subsidized) imports have contributed to unfavorable price ratios. Indeed, the market share of corn has been reduced or has stagnated in the Andean countries, Mexico, and Central America. A similar trend is apparent for tubers and legumes in Brazil and the Andean countries, and for beans in the Caribbean, Mexico, and Central America. By contrast, the market share of wheat, rice, and vegetable oil is increasing (Schejtman, 1994).



Source: Schejtman (1994).

The nine countries in which the availability of foodstuffs is precarious or critical—using the parameter of universal satisfaction of basic food requirements—are also highly dependent on imported foodstuffs for a significant proportion of their domestic supply. Hence estimates of the impact of economic liberalization on food security are particularly important.

Global integration has simply consolidated certain longer-standing trends in a slow, systematic process of changing consumption patterns.

Native products often based on family agriculture are losing their relative importance. Nonetheless, if projections regarding the effect on prices of eliminating subsidies and other distortions were to become reality, basic food prices and costs for urban consumers would increase, along with the costs for the small agricultural producers who are net buyers of foodstuffs, if the new prices could not lead to higher production.

5.2 Inequality and Poverty in Rural Latin American Society

In general, Latin America has among the greatest levels of inequality in income distribution in the world. The greater the inequality, the greater the growth rate of GDP needed to reduce poverty by a given percentage. Many studies analyzing the links between integration and poverty do so by way of the relationship between liberalization and income distribution, arguing that improved income distribution and growth indicate lower or declining poverty.

Distribution of Income Inequality

Inequality in the distribution of income has a strong effect on the rural societies of Latin America. There is a relationship between inequality in the distribution of income and the ability to alleviate poverty. As illustrated by de Ferranti and others (2004: 6), “Brazil could cut poverty in half in 10 years with a 3 percent growth rate and a 5 percent improvement in the Gini index. The country would take 30 years to reach that same objective with a 3 percent growth rate but without improving income distribution.”

Table 5.6 illustrates trends in income distribution during the 1990s and early 2000s, measured using the Gini index.⁹ The most recent information indicates that among those countries where the situation in rural and urban areas can be compared, income-distribution inequality is less acute in rural areas than in urban areas in eight countries. Income distribution is worse in rural areas than in urban areas in Bolivia, Costa Rica, Mexico, and Paraguay.

A second conclusion derived from table 5.6 is that the rural areas of Latin America are making greater progress toward improving income distribution

⁹ By comparison, the Gini index for the United States in 1997 was 40.8, and for Italy in 1998 it was 36.0.

■ **TABLE 5.6** Trends in the Distribution of Income in Rural and Urban Sectors, 1990s and Early 2000s

Country	Rural sector				Urban sector			
	Year	Gini	Year	Gini	Year	Gini	Year	Gini
Argentina	—	—	—	—	1990	50.1	2002	59.0
Bolivia	1997	63.7	2002	63.2	1989	53.8	2002	55.4
Brazil	1990	54.8	2001	58.1	1990	60.6	2001	62.8
Chile	1990	57.8	2003	50.7	1990	54.2	2003	54.6
Colombia	1994	57.0	2002	50.7	1994	57.9	2002	57.5
Costa Rica	1990	41.9	2002	48.1	1990	41.9	2002	46.5
Dominican Republic	1997	48.3	2002	47.3	1997	50.9	2002	54.8
Ecuador	—	—	—	—	1990	46.1	2002	51.3
El Salvador	1995	44.2	2001	47.7	1995	46.6	2001	47.7
Guatemala	1989	51.3	2002	47.0	1989	55.8	2002	52.4
Honduras	1990	55.8	2002	51.9	1990	56.1	2002	53.3
Mexico	1989	45.3	2002	49.8	1989	53.0	2002	47.7
Nicaragua	1993	53.6	2001	50.6	1993	54.9	2001	56.0
Panama	—	—	2002	51.5	1991	54.5	2002	51.5
Paraguay	1999	57.0	2000	54.8	1999	49.7	2000	51.1
Peru	1997	45.1	2001	43.9	1997	47.3	2001	47.7
Uruguay	—	—	—	—	1990	49.2	2002	45.5
Venezuela	1990	43.1	—	—	1990	46.4	—	—

Source: ECLAC (2004a).

Note: — = data not available.

than the urban areas, which have even experienced a slight deterioration during the 1990s and the early 2000s. Of the 13 countries for which changes in income distribution in rural areas in both time periods can be measured, 9 have improved income distribution in rural areas, whereas only 4 of those 13 countries have made similar progress in regard to income distribution in urban areas. Lamentably, at an aggregate regional level, the rural distribution of income has deteriorated because of the major weight of the two most populous countries: Brazil (3-point retrogression) and Mexico (retrogression of almost 5 points).

In Latin America, a very small group of people have a very high percentage of the total income. According to the World Bank (2002), the proportion of the wealthiest 10 percent of the population in 114 countries represents 31.7 percent (average weighted) of income or consumption. In countries where

■ **TABLE 5.7** Percentage of Consumption or of National Income Captured by the Wealthiest 10 Percent of the Population and Global Ranking of Concentration of Income or Consumption

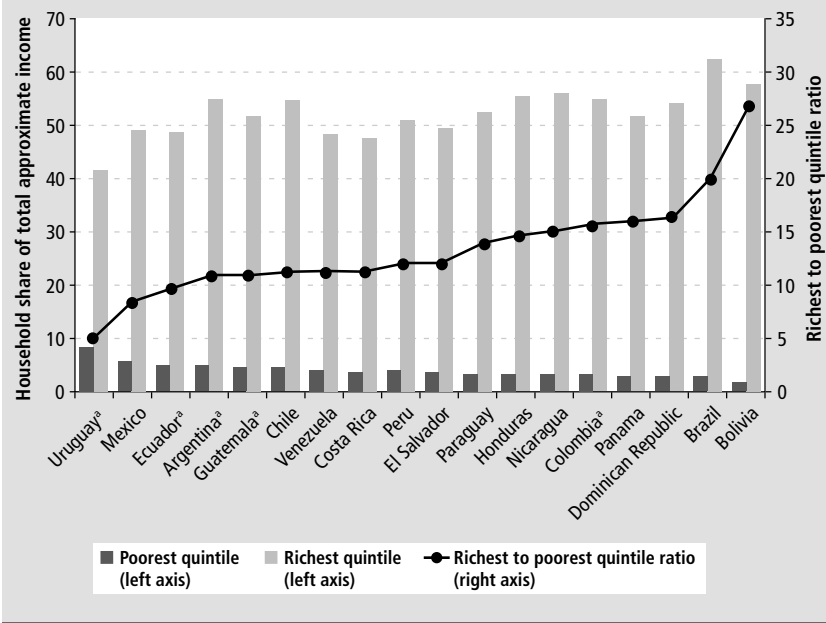
Country	Percentage of consumption or of national income	Global ranking of concentration of income or consumption
Nicaragua	48.8	2
Brazil	48.0	3
Colombia	46.1	6
Guatemala	46.0	7
Chile	45.6	9
Paraguay	43.8	10
Honduras	42.7	13
Mexico	41.7	15
El Salvador	39.5	21
Dominican Republic	37.8	25
Venezuela	36.5	28
Panama	35.6	30
Peru	35.4	31
Costa Rica	34.6	34
Ecuador	33.8	36
Uruguay	32.7	42
Bolivia	32.0	46
World (114 countries)	31.7	

Source: World Bank (2002).

income distribution is very good, the proportion is 25 percent or less. Table 5.7 illustrates the situation in certain Latin American countries. Of the 25 countries in the world where the wealthiest 10 percent of the population receives the highest percentage of income, 10 are Latin American countries, where the income of the wealthiest quintile ranges from five times (Uruguay) to 26 times (Bolivia) that of the poorest quintile (figure 5.6). The extreme inequality of income distribution in Brazil has a major effect on the aggregate regional indicator.

If the wealthiest 10 percent of the population were removed from the calculation of income distribution in Latin America, all countries would have a Gini index similar to that of the United States or even to that of the European countries (figure 5.7). The effect of excluding the wealthiest 10

■ **FIGURE 5.6 Household Share of Total Approximate Income by Quintile, 2002**



Sources: Dirven (2004); personal communication; data from ECLAC based on projections using household surveys.

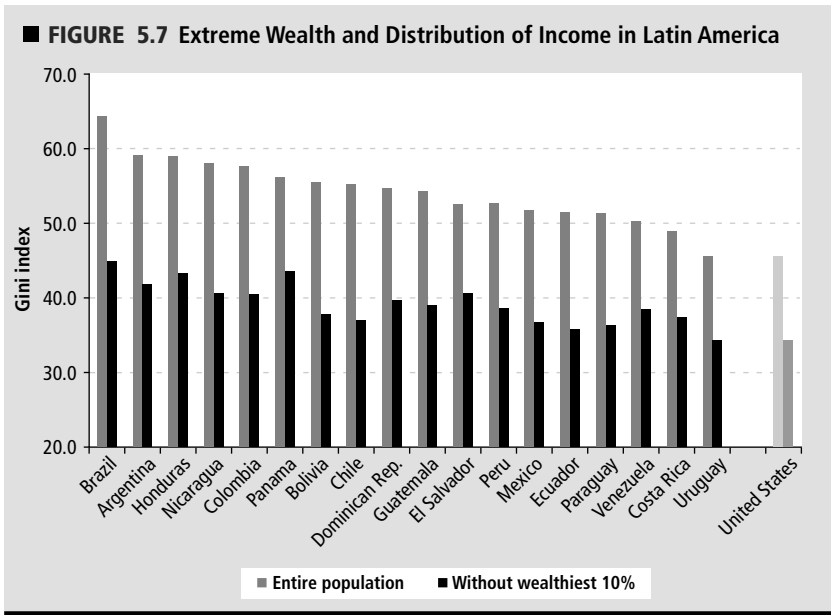
^a urban area.

percent in the United States (shown in the last bar on the right side) is modest in comparison to the great impact of doing so in countries such as Chile, Nicaragua, Argentina, Brazil, Colombia, or Guatemala.

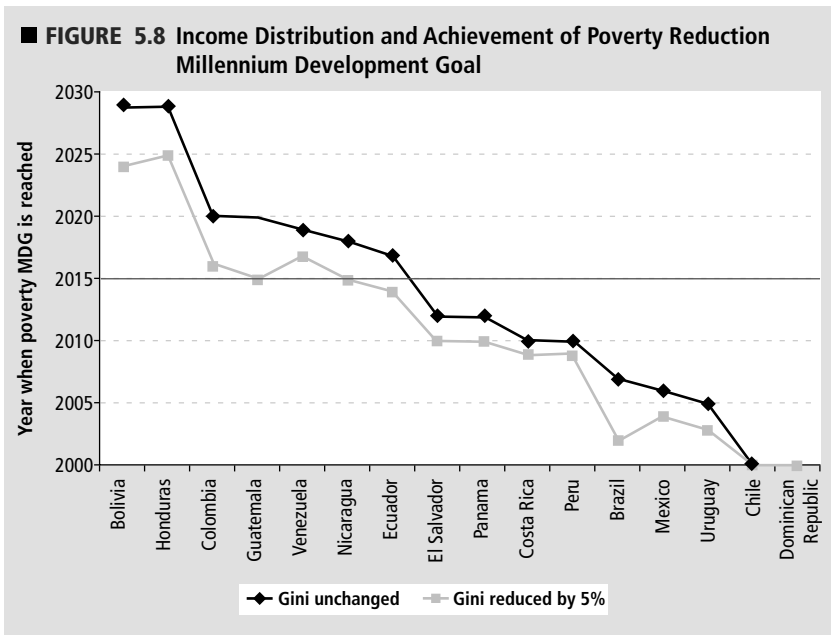
Figure 5.8 shows that a 5 percent improvement in the Gini index of income distribution would accelerate the reduction of poverty in all countries. Without improving income distribution, seven countries (Bolivia, Honduras, Colombia, Guatemala, Venezuela, Nicaragua, and Ecuador) will not be able to meet the Millennium Development Goal of a 50 percent reduction in extreme poverty by 2015. An improvement in income distribution as indicated in figure 5.8 would mean that only two countries would fail to meet the goal.

Rural Poverty

In the 20 years in which the economies of the region have been liberalized and internationalized, the number of poor rural inhabitants—and especially



Source: ECLAC (2004a).



Source: León and others (2004).

■ TABLE 5.8 Magnitude and Incidence of Poverty and Indigence, 1980–2002

Variable	Magnitude (millions)		Incidence (percentage)	
	1980	2002	1980	2002
Poor				
Rural	73.2	77.5	59.9	61.8
Urban	68.4	152.8	29.8	38.4
Nonindigent poor				
Rural	33.2	30.0	27.2	23.9
Urban	44.1	99.0	19.2	24.9
Indigent poor				
Rural	40.0	47.5	32.7	37.9
Urban	24.3	53.7 ^a	10.6	13.5 ^a

Source: ECLAC and CELADE (2004).

^a 2004.

the number of rural inhabitants who do not have sufficient income for food—has grown. A larger part of the rural population is poor, and rural poverty is more acute than it was 20 years ago.

Six of every 10 rural inhabitants in Latin America and the Caribbean were living in poverty at the start of the new millennium, and 4 of every 10 people lacked sufficient income to satisfy their food needs (table 5.8). The situation is worse than it was 20 years ago, even though the rural poverty rate has increased by only two points. The increase stems from a significant growth in indigence and a drop in nonindigent poor people.

The deterioration has been greatest in urban areas: the number of urban poor more than doubled and the number of indigents (income below food requirements) increased by 22 percent between 1980 and 2002. The rates of poverty and extreme poverty in urban areas have increased to a greater extent than in rural areas, principally because of the expulsion of the poor from rural areas. Using econometric analysis, De Janvry and Sadoulet (2000) conclude that between 60 percent and 84 percent (depending on the decade) of the decrease in the ratio of rural poor to urban poor is explained by rural-to-urban migration.

An analysis at the country level (table 5.9) shows that between 1987 and 2001, Brazil reduced the rural poverty rate by 10 percent and the rate of extreme rural poverty by 13 percent. This development, in a country with 26 percent of the region's total rural population, is the main reason the aggregate regional situation was not more negative.

■ TABLE 5.9 Trends in Rural Poverty and Indigence Rates by Country

Country	Poverty rate (percentage)		Indigence rate (percentage)	
	1980s or 1990s (year)	2000s (year)	1980s or 1990s (year)	2000s (year)
Argentina	19.0 (1980)	—	5.1 (1980)	—
Bolivia	—	79.2 (2002)	—	62.9 (2002)
Brazil	65.9 (1987)	55.2 (2001)	41.1 (1987)	28.0 (2001)
Chile	51.5 (1987)	20.1 (2003)	20.6 (1987)	6.2 (2003)
Colombia	47.7 (1980)	52.0 (2002)	23.5 (1980)	26.7 (2002)
Costa Rica	28.4 (1981)	24.3 (2002)	7.6 (1981)	12.0 (2002)
Dominican Republic	39.4 (1997)	50.7 (2002)	17.9 (1997)	26.3 (2002)
El Salvador	64.4 (1995)	62.4 (2001)	29.9 (1995)	33.3 (2001)
Guatemala	83.7 (1980)	68.2 (2002)	51.5 (1980)	37.6 (2002)
Honduras	88.1 (1990)	86.1 (2002)	72.9 (1990)	69.5 (2002)
Mexico	53.5 (1984)	51.2 (2002)	25.4 (1984)	21.9 (2002)
Nicaragua	82.7 (1993)	77.0 (2001)	62.8 (1993)	55.0 (2001)
Panama	51.9 (1986)	48.5 (2002)	28.4 (1986)	31.5 (2002)
Paraguay	—	73.6 (2001)	—	50.3 (2001)
Peru	72.7 (1997)	78.4 (2001)	52.7 (1997)	51.3 (2001)
Uruguay	26.7 (1981)	—	9.1 (1981)	—
Venezuela	43.0 (1981)	—	19.3 (1992)	—

Source: ECLAC (2002).

Note: — = data not available.

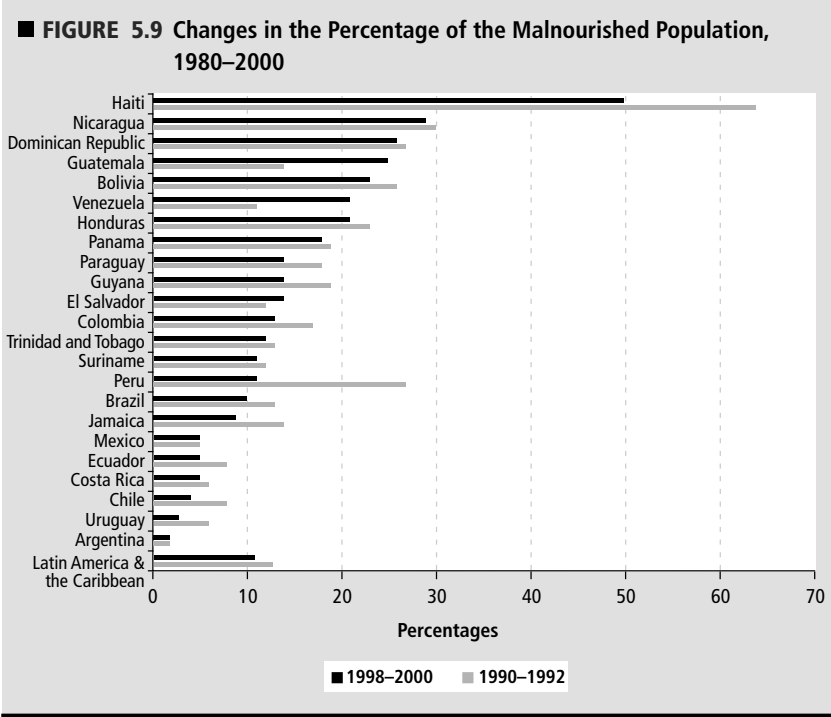
Except for Brazil and the countries for which ECLAC reports statistics, only Guatemala and Chile showed significant progress in reducing poverty during the 1990s. Panama is making progress on poverty but is slightly regressing in its rural indigence rate. Of the 12 countries for which information is available to compare rural poverty across two decades, the rural poverty rate is above 50 percent in 9 of them.

Using World Bank and the United Nations Development Programme (UNDP) data published in 1990, the International Fund for Agricultural Development (IFAD, 1993) rated seven countries of the region as having critical rural poverty, meaning that between 75 percent and 97 percent of their rural population lives in poverty. Another nine countries, plus CARICOM, have a “high incidence,” with between 51 percent and 73 percent of their rural populations living in poverty. Only four countries (Argentina, Costa Rica, Uruguay, and Cuba) belong to the “low-incidence” group of countries in which less than 50 percent of the rural population lives in poverty.

Even in countries where most of the population is urban, such as Brazil, Colombia, Mexico, and Peru, most of the extremely poor live in rural regions (Valdés and Wiens, 1996). In all countries of the region, the great majority of people whose income places them in the poorest decile of the population are rural inhabitants.

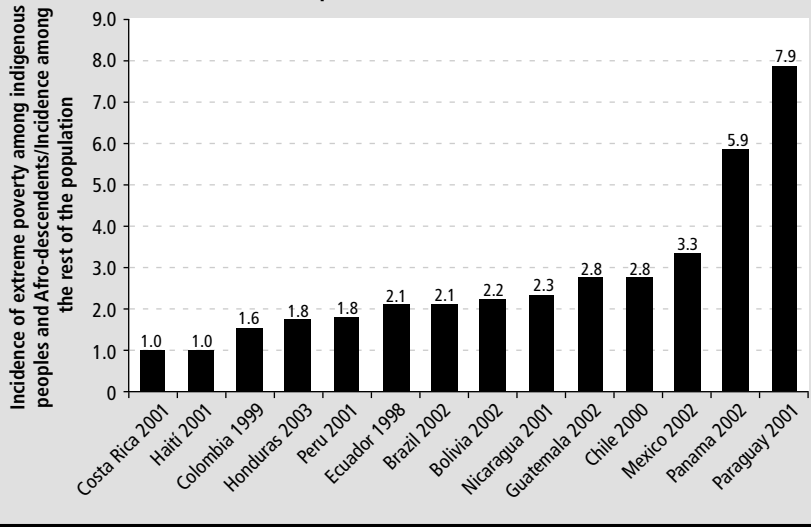
Another way to look at poverty is the access that families or individuals have to adequate food. Malnutrition rates constitute the most eloquent indicator of family access to food. In 2000, 11 percent of the population of Latin America (54 million people) was malnourished and almost 8 percent of children under the age of five had low weight-for-age ratios. The highest levels of malnutrition corresponded precisely to the group of countries with precarious or critical levels of aggregate food availability and with a high level of external dependency in the FES (figure 5.9).

Figure 5.10 shows that in all countries except Costa Rica and Haiti, indigenous peoples and those of African descent are affected by poverty to a significantly greater extent than the rest of the population.



Source: Based on data from FAO (2002).

■ **FIGURE 5.10** Incidence of Extreme Poverty among Indigenous Peoples and African Descendants as a Multiple of the Poverty Rate for the Rest of the Population



Sources: Dirven (2004); data from ECLAC based on projections using household surveys.

A recent World Bank study (Hall and Patrinos, 2005) conducted in the five countries that have the largest indigenous populations in the region (Bolivia, Ecuador, Guatemala, Mexico, and Peru) shows that the rates of poverty reduction among this population are between 30 and 140 times lower than among the nonindigenous population.

In Bolivia, 62 percent of the population is indigenous and 72 percent of the rural population speaks Quechua, Aymara, and other indigenous languages. Seventy-four percent of the indigenous peoples are poor, compared with 53 percent of the nonindigenous population. Over the past decade, poverty among indigenous people has not diminished in practical terms (Hall and Patrinos, 2005).

In Mexico, the indigenous population represents 11 percent of the total population. Nearly three-quarters (72 percent) of the indigenous peoples live in rural communities and 90 percent are poor, a rate practically the same as that in the early 1990s (Hall and Patrinos, 2005).

In Ecuador, 9 percent of households include at least one person identifying himself or herself as indigenous. Seventy-six percent of the indigenous rural population is indigent, and another 20 percent live in nonindigent

poverty. Some 61 percent of the nonindigenous population is poor (Hall and Patrinos, 2005).

In Peru, 25 percent of all households are headed by persons who speak an indigenous language as their principal tongue and 46 percent of households include at least one person whose parents or grandparents spoke an indigenous language. Poverty affects about 62 percent of the indigenous peoples, compared to 43 percent of the nonindigenous population. Almost a quarter (22 percent) of the indigenous peoples are indigent, which is twice the rate of the nonindigenous population (Hall and Patrinos, 2005).

Thirty-nine percent of Guatemalans define themselves as indigenous. Poverty and indigence among the indigenous and nonindigenous populations dropped between 1989 and 2000, but at very different rates. Poverty fell among indigenous peoples by 14 percent and among nonindigenous people by 25 percent. For extreme poverty, the decline was 25 percent among the nonindigenous population and less than 5 percent among the indigenous peoples (Hall and Patrinos, 2005).

Peasants and Poverty

The liberalization and integration processes have affected the various strata of agricultural producers to various extents. Peasants have shouldered significant costs, as reflected by poverty rates among “self-employed workers other than professionals and technicians in agriculture, forestry, and fishing” (ECLAC, 2004a), the equivalent of small rural producers. Table 5.10 shows the differences in poverty rates for peasant households compared to the total rural population of the country. For example, in 1997, 89 percent of Bolivia’s peasants were poor compared to 79 percent of the country’s rural inhabitants—a difference of 10 percent. Table 5.10 shows that the poverty rate was greater among small rural producers than in the general rural population in the 1990s in 10 of the 15 countries studied. From the 1990s to the 2000s, the situation improved in only four countries: the Dominican Republic (with a relative gain of 12 percent), Colombia (10 percent), Brazil (5 percent), and Bolivia (1 percent).

From the 1990s to the 2000s, small rural producers became poorer than the general rural population in 10 countries: Costa Rica (relative regression of 22 percent), Panama (15 percent), Mexico (14 percent), Chile (10 percent), El Salvador (9 percent), Guatemala (7 percent), Nicaragua (4 percent), Honduras

■ **TABLE 5.10** Changes in the Poverty Rate of Small Rural Producers Relative to the Poverty Rate in the Rural Population

Country	Percentage of small rural producers ^a in poverty relative to the percentage of the total rural population in poverty	
	1990s	Since 2000
Bolivia	+10	+9
Brazil	+3	–2
Chile	–16	–6
Colombia	+13	+3
Costa Rica	0	+22
Dominican Republic	+3	–9
El Salvador	+8	+17
Guatemala	–2	+5
Honduras	+2	+5
Mexico	–3	+11
Nicaragua	+6	+10
Panama	+6	+21
Paraguay	+5	+7
Peru	+4	+4
Venezuela	–11	–12

Source: ECLAC (2004a).

^a Self-employed workers other than professionals and technicians in agriculture, forestry, and fishing.

(3 percent), Paraguay (2 percent), and Venezuela (1 percent). Peru has undergone no relative changes.

Quijandría and others (2000) describe the rural poor in broad categories of life strategies and ways of organizing agricultural production (table 5.11). Approximately 60 percent of the rural poor belong to social strata burdened by major handicaps in competing and participating successfully in liberalization and integration processes.

In micro- and small agricultural enterprises, some strata have access to land in sufficient quantities to be able to realistically have the option of participating in more dynamic, competitive markets. Table 5.12 shows estimates (probably with a significant margin of error, given the diversity of sources and the general nature of available data) of the number of peasant units that can potentially and viably gain access to markets on the basis of their land holdings. On that basis, some 7.3 million peasant families in Latin America have more potential to operate commercially.

■ **TABLE 5.11** Distribution of the Rural Poor by Types of Life Strategies and Organizational Forms of Agricultural Production

Life strategy	Rural poor (percent)	Rural poor (number)
Herders in the puna	0.9	700,000
Small livestock producers	5.8	4,650,000
Small agricultural producers	10.6	8,500,000
Small mixed producers	14.1	11,300,000
Subsistence farmers	19.4	15,500,000
Landless peasants	9.4	7,500,000
Rural day laborers	6.9	5,500,000
Peasant communities	30.4	24,300,000
Indigenous communities	1.2	950,000
Artisan fishermen	1.4	1,100,000
Total	100.0	80,000,000

Source: Adapted from Quijandria and others (2000).

■ **TABLE 5.12** Importance of Small Farms with Sufficient Land Potential to Operate Commercially

Country	Year	Stratum (hectares)	Total number of farms in the stratum (thousands)	Percentage of total farms in the country	Percentage of total available land
Brazil ^a	1996	variable	2,222	—	—
Chile ^b	1994	variable	176	53	16
Colombia	1988	5–10	232	15	4
Honduras	1993	5–10	53	16	7
Mexico	1997	5–10	2,520	24	—
Mexico	1997	10–18	1,788	17	—
Nicaragua	1997	3–15	—	30	—
Paraguay	1991	5–10	67	22	2
Peru	1994	5–10	262	14	5

Sources: For Brazil, INCRA and FAO (1999); for Chile, ODEPA (2000); for Mexico, De Janvry and Sadoulet (2000); for Nicaragua, Davis and others (1997); and for the rest, FAO (1997).

Note: — = data not available.

^a Includes only the strata of family farms that are “very integrated” or “integrated” into the markets, according to the INCRA/FAO study.

^b Includes only the category of “small entrepreneurial producer” in the ODEPA (2000) study.

Regional Distribution of the Costs and Benefits of Liberalization

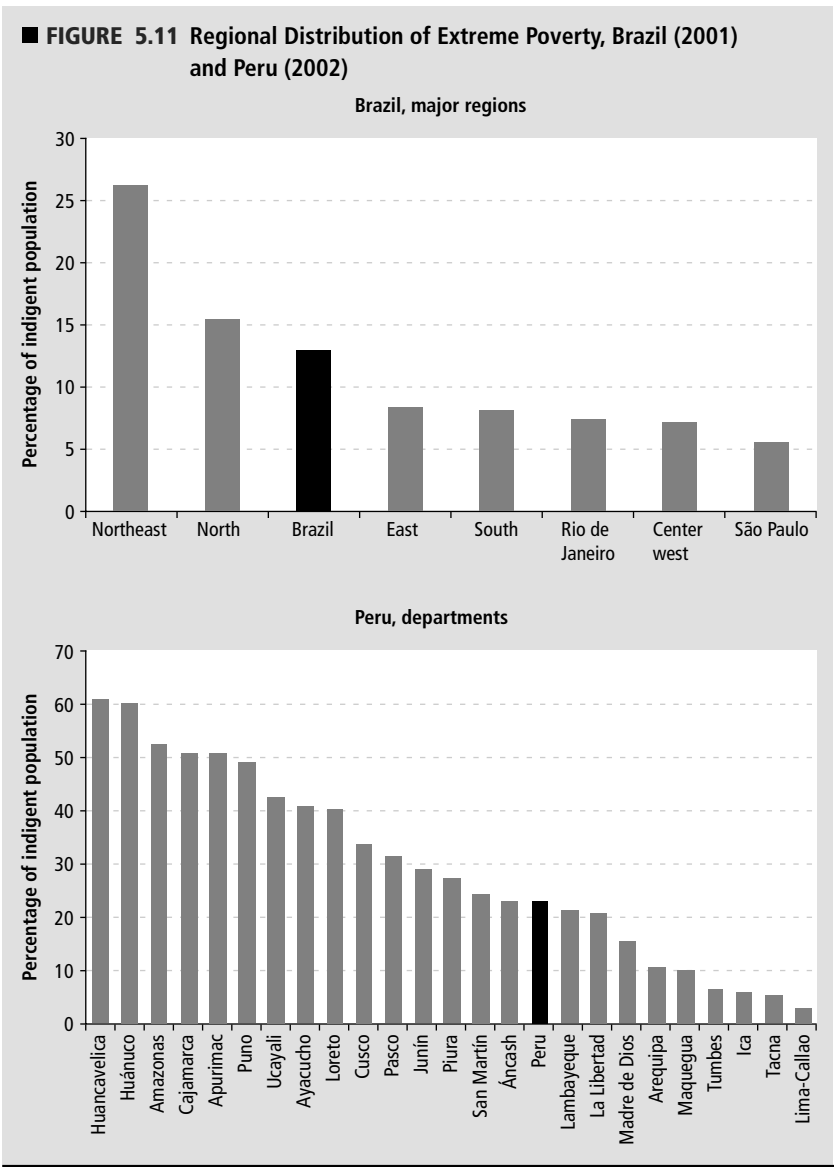
Among other things, the liberalization and integration processes are striking for the very unequal distribution of their costs and benefits over the region. Berdegue (1996) estimated the spatial distribution of rural poverty in 11 megadomains using the Regional Fund for Agricultural Technology (FONTAGRO) classification. Table 5.13 shows an updated version of that analysis, reflecting the data on rural poverty available for the late 1990s. Approximately a third of the region's rural poor are located in large areas that have been adversely affected by the liberalization and integration processes. At least half of the rural poor are located in large areas that have been most favored by the liberalization and integration processes.

Figure 5.11 illustrates the argument with the cases of Brazil and Peru. In Brazil, the dynamic regions of the south and central-west—clear beneficiaries of the liberalization and integration processes—have extreme poverty rates that are five times lower than in the northeast. In Peru, interregional differences are even more dramatic. For example, departments such as Huancavelica, isolated in the Andes and with an agrarian economy that cannot compete against imported foodstuffs even in the domestic market, have extreme

■ **TABLE 5.13** General Estimate of the Spatial Distribution of Rural Poverty, Using FONTAGRO Megadomains of the Late 1990s

FONTAGRO megadomain	Rural poor (millions)	Percentage
Pampas, Uruguay, Brazil, and Paraguay	6.4	8
Central and Southern Chile and Western Argentina	3.4	4
Chaco	5.8	8
Andean valleys and moderate-height hillsides	6.6	9
High Andean systems	6.0	8
Tropical savannahs	3.6	5
Amazon rain forests	3.3	4
Central America and Southern Mexico	11.9	15
Caribbean	9.2	12
Pacific Coast between Peru and Mexico	13.4	17
Northern Mexico and Southern United States	7.6	10
Total	77.2	100

Sources: Based on IFAD (1993), FAO (1998), and ECLAC (2002).

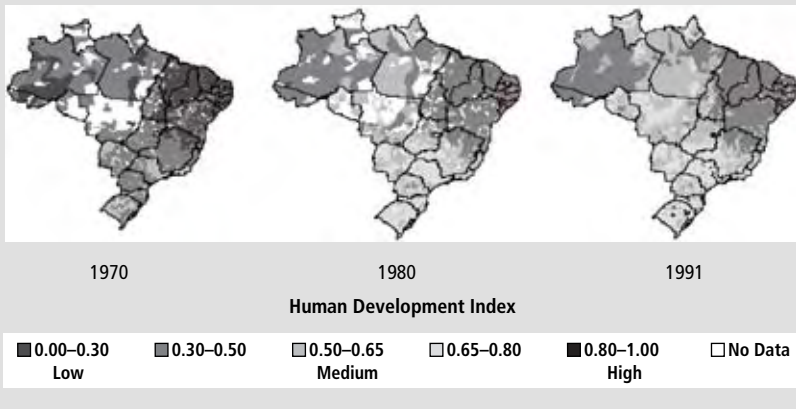


Sources: Dirven (2004); data from ECLAC based on projections using household surveys.

poverty rates 12 times higher than those of departments with an agrarian export-oriented economy, such as Ilo on the Peruvian Coast.

Figure 5.12 shows that the overall improvement in welfare for Brazil, measured in terms of the Human Development Index of the UNDP, has not

■ **FIGURE 5.12** Distribution of Welfare among the Municipalities of Brazil, 1970–91



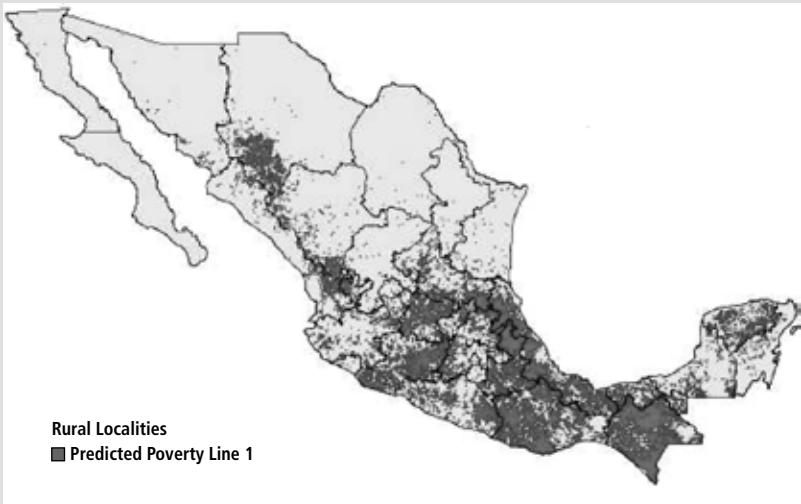
Source: Henninger and Snel (2002).

translated into lower regional gaps. To reduce this regional imbalance over time, the liberalization and integration processes would have to offer more benefit or cause less harm to the regions that lag behind the most. This has not occurred to any significant extent in the past 15–20 years in Brazil or elsewhere in the region.

Bellón and others (2004) analyzed data from 104,000 rural communities in Mexico with fewer than 2,500 inhabitants. Figure 5.13 shows the regional distribution of the rural localities where average food consumption is insufficient to satisfy minimum nutritional requirements. As regards rural poverty, there are two Mexicos. Figure 5.14 illustrates the relationship between the spatial distribution of rural poverty and the potential to compete in an agricultural regime open to international trade. The zones in Mexico where the commercial production of corn and wheat is concentrated are almost wholly distinct from those where rural poverty is concentrated. Since the data are from 2000 and later, they already reflect the effects of NAFTA and of other liberalization and integration processes in terms of the location of both agricultural production and rural poverty.

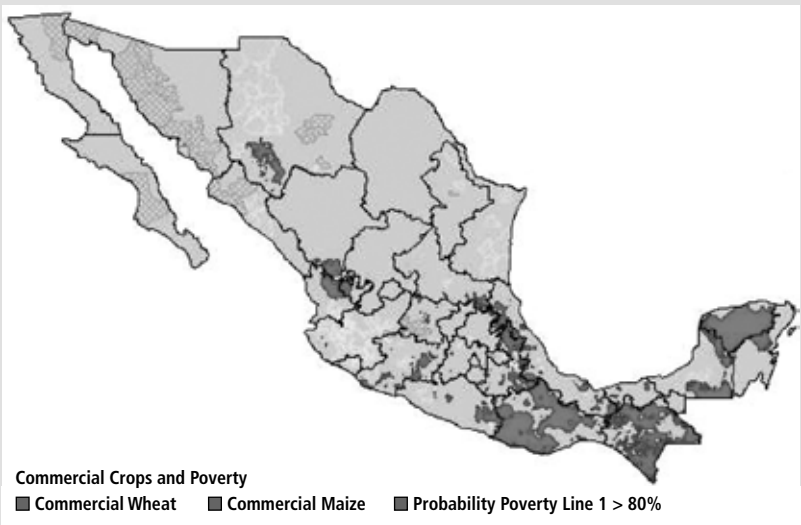
The situation in Ecuador is no different. Figure 5.15 shows that both extreme poverty (consumption of food below the minimum nutritional requirements) and inequality in the consumption of food are concentrated in the Sierra and Amazonia, far from the coastal regions that have benefited from the liberalization and integration processes.

■ **FIGURE 5.13** Mexico: Distribution of Rural Localities in a Situation of Extreme Poverty



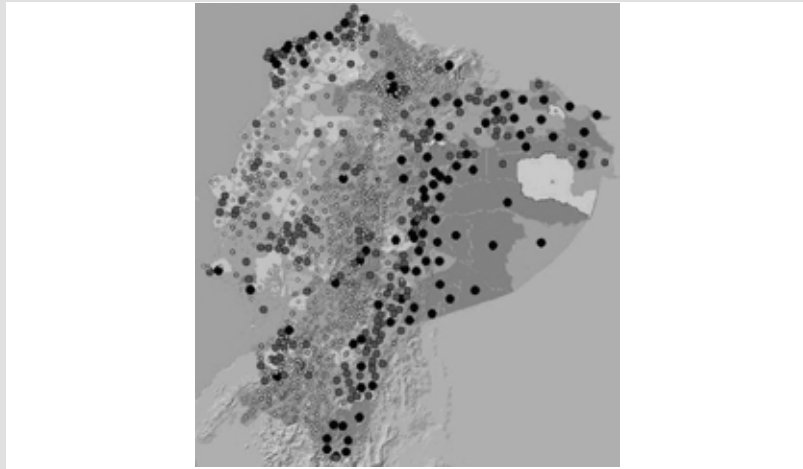
Source: Bellón and others (2004).

■ **FIGURE 5.14** Mexican Municipalities That Produce Corn and Wheat Commercially and Municipalities with a High Probability (> 80 percent) of Extreme Poverty



Source: Bellón and others (2004).

■ **FIGURE 5.15** Percentage of the Population below the Extreme Poverty Line and Inequality in Food Consumption



Source: Farrow and others (2005).

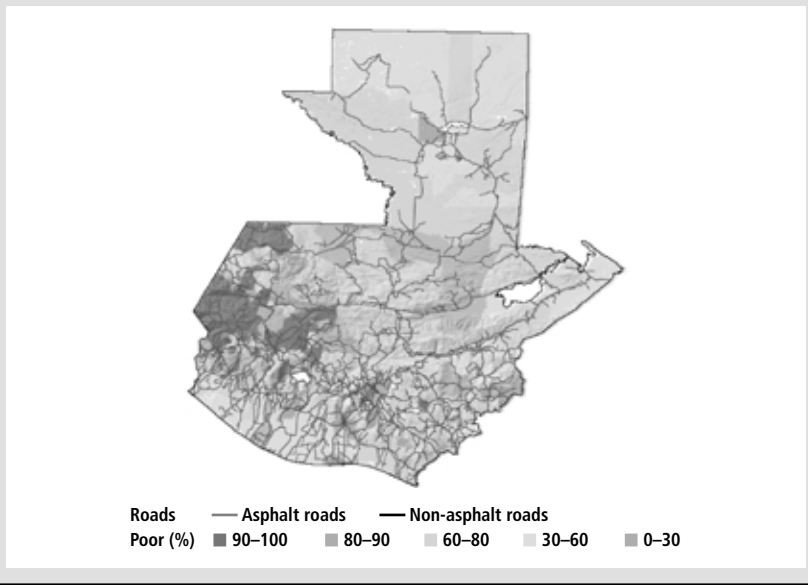
Note: The areas shaded in darkest gray indicate a greater incidence of extreme poverty, and black points signify high inequality in food consumption (Gini index).

Guatemala resembles the other countries in this respect (figure 5.16). Poverty is concentrated in regions far from those that have succeeded in integrating themselves more positively into international trade, and especially distant from the regions that have undertaken promising projects to convert productive assets to nontraditional export products. Figure 5.16 is also interesting because it offers a partial explanation of the separation of highly impoverished regions from those with agricultural activity that is conducive to exporting—which is the relative lack of roads. A dense road network serves the Pacific coast (lower part of the map), but there are few roads in the highlands bordering Mexico, where poverty affects 90 percent of the population. An area with few roads is at an obvious disadvantage in accessing markets.

Illustrative Cases

This section explores the relationship between liberalization and integration, on the one hand, and the social welfare of rural populations, on the other, for certain countries or subregions of Latin America. The examples are used

■ FIGURE 5.16 Regional Distribution of Poverty and of Roads in Guatemala



Source: Henninger and Snel (2002).

to illustrate the more general argument that it is not possible to demonstrate a direct relationship.

Mexico. When NAFTA became effective in 1994, Mexico took a sharp turn in its policy of international insertion. Until 1994, the sum of its exports and imports was slightly less than a third of its GDP, a rate similar to that of the Andean countries. Since 2000, the indicator has ranged between 55 percent and 60 percent—almost double that of the preceding period. Agricultural exports were already rising and expanded by 70 percent over the early 1990s. The share of agricultural trade in total agricultural production rose significantly with the implementation of NAFTA, averaging 39 percent for the 1994–2001 period (Yúnez-Naude and Barceinas Paredes, 2002).

Some 87 percent of Mexico's imports and 97 percent of its exports are accounted for by agricultural trade with the United States. Before and since NAFTA, the main exports have been fruits and vegetables and the chief imports have been grains, animal feed, and oilseed. Mexico traditionally has run an agricultural trade deficit with the United States, and the deficit increased by more than 60 percent after NAFTA went into effect.

Yúnez-Naude and Barceinas Paredes (2002) show that the irrigated area where the principal grains and oilseed were cultivated, and which was considered vulnerable under NAFTA, shrank as the agreement went into effect, but yield increased. The total production of these vulnerable products remained more or less stable. Ana de Ita (2003) notes that the large grain producers in the state of Sinaloa have reaped the greatest benefits from public policies designed to compensate for or complement NAFTA's implementation, especially those intended to support marketing. Support is given on the basis of each ton of corn marketed, and hence large entrepreneurs receive the biggest share of public funds. This acts as an incentive to concentrate land. In the rain-dependent farming areas where peasants predominate, yields have remained constant but the size of the cultivated area and production have increased.

Yúnez-Naude and Barceinas Paredes (2002) summarize the changes to Mexican agriculture since NAFTA as follows:

- Domestic prices of the main tradable products have fallen in real terms and are nearing international prices. Nadal (2000) argues that the 15-year transition period for corn agreed upon in NAFTA was later reduced to 30 months because of the convergence of domestic and international prices.
- Agricultural trade (imports and exports) has increased markedly, tending to skew Mexican agriculture toward international trade.
- Yields of importable and exportable products have increased.
- Increases in productivity have been concentrated in the irrigated zones.
- Domestic production of sensitive products such as corn has not collapsed.
- Rural-to-urban migration has not dramatically increased.
- Private agricultural lending has declined.

They explain that these effects are the combined result of NAFTA, the macro-economic shocks that have affected the Mexican economy (in particular, the devaluation of the peso in 1995), and the compensatory agricultural policies established by the Mexican government.

Davis (2000) analyzed the effects of these great changes on the peasant sector, and particularly on Mexican *ejido* collective farm members. The peasants have reverted to their traditional strategy of diversifying risk. Depending on available assets, households pursue strategies such as idiosyncratically combining the production of traditional products for self-consumption or

for small-scale trade, expanding the areas for higher-value crops, accumulating livestock, engaging in wage-earning employment or self-employment outside agriculture, and, above all, underemployment or migration to the United States.

Nadal (2000) analyzes NAFTA's impact on corn production in Mexico. He explains how subsistence producers, who comprise 40 percent of corn producers, responded to the fall in domestic prices by expanding cultivated areas against all the predictions made using econometric models.

Henneberry and Nelson (n.d.) carried out a study in the state of Tlaxcala, where there is a strong peasant presence and significant industrial development. Their study confirms how rural households articulate diversified job-creation strategies, taking into account their available assets, the real prices of their products on the local markets, and opportunities for nonagricultural employment.

The peasant sector's adaptation strategies take account of the whole environment, including job opportunities in other sectors of the economy. In Mexico, the economy was not capable of creating formal employment in net terms during the 2000–4 period.¹⁰ The creation of 500,000 new jobs in the manufacturing sector between 1994 and 2002 was more than offset by the loss of 1.3 million jobs in the rural sector (Audley and others, 2003). The informal sector, on the other hand, has grown quickly: 11 million Mexicans, or a quarter of the labor force, work in the informal sector. Goldberg and Pavcnik (2004a, 2004b) examined several cases of economic liberalization and concluded that tariff reductions can translate into greater inequality if they are associated with a greater probability of working in the informal sector.

Together with labor market conditions, product market imperfections and related transaction costs also condition peasants' responses to economic liberalization and trade integration, since many peasants may find that even with declines in real prices for products, producing for self-consumption remains more beneficial (De Janvry and Sadoulet, 1998).

Starting with NAFTA's going into effect, the states of southern Mexico lost ground in terms of their contribution to per capita GDP. While NAFTA has been in effect, regional differentiation has intensified. Referring to Oaxaca, Guerrero, and Chiapas, Esquivel and others (2002) ask, "Why didn't NAFTA

¹⁰ Internet version of *La Jornada* (May 21, 2005), "Cero creación de empleo formal en el gobierno de Vicente Fox," citing research from the Economist Intelligence Unit.

reach the South?” NAFTA failed to reach the south because of the region’s lack of infrastructure, low levels of human capital, deficient social cohesion, and problems with the institutions of governance.

Todd and others (2004) conclude from Mexico’s experience with NAFTA that to benefit from liberalization, and specifically from agricultural trade liberalization, solid policies and support programs are needed for the transition. In particular, they indicate that direct income transfer programs such as the program of direct support for rural areas (Programa de Apoyos Directos al Campo, PROCAMPO) are insufficient to sustain the change to new, export-oriented crops. Moreover, small producers need access to capital markets to finance production conversion to product lines with competitive advantages. Their transaction costs must also be lowered through investments in infrastructure and the modernization of product markets. Also needed is access to information and to technical assistance of sufficient quality to be useful in dynamic, highly competitive markets.

Central America. The relationship between liberalization and integration and the welfare of rural societies is especially important for Central America, for several reasons:

- The Central American economies still have a major agricultural component that represents between 9 percent (Costa Rica and El Salvador) and 23 percent (Guatemala) of GDP.
- The rural population still comprises 40–60 percent of the total population, depending upon the country, and agriculture remains the determining factor in job creation.
- Agricultural exports comprise between 34 percent (El Salvador) and 56 percent (Guatemala) of total exports.
- In 2002 between 24 percent (Costa Rica) and 86 percent (Honduras) of the total rural population was poor.

Central America exports a large quantity of agricultural products to the United States. Coffee and fruits (especially bananas) account for some 60 percent of the value of those exports. Coffee is a core crop for small Central American agriculture. Berdegúe and Escobar (2004) estimate that there are 250,000 coffee-growing peasants and small producers in Central America. Central American coffee and bananas already enter the United States with

a zero tariff, and hence these subsectors are not expected to receive any additional benefit from the Central America Free Trade Agreement (CAFTA). Those Central American agricultural products that will benefit from reduced tariffs under CAFTA are not very important in the peasants' production systems.

Monge-González and others (n.d.) identify agricultural or agroindustrial products imported by the United States and in which Costa Rica and El Salvador are internationally competitive but do not currently export to the United States because of quasi-tariff barriers. These products are imported and would presumably benefit from an FTA such as CAFTA. They are basically the same for the two countries, consisting mainly of certain dairy products and sugar derivatives. Considering the two countries together, the current exports of products that could benefit greatly from CAFTA amount to less than \$500,000 a year.

Todd and others (2004) recently analyzed the probable effects of CAFTA on agriculture and on the rural economies of Central America. They state that the benefits of trade liberalization will be hard to capture without substantial changes to rural policies and programs. They note the need to develop the rural infrastructure to reduce transaction costs, to create direct support programs for accessing new markets such as those of the United States, and to improve the countries' phytosanitary conditions. They conclude that peasants who produce basic food for the domestic market and unskilled rural workers are among those most at risk of being harmed by the liberalization of trade under CAFTA. To help them adapt to the new environment, direct income-transfer programs and technical and financial assistance will be necessary. It is open to debate whether the region's countries have the institutional and financial capacity to design and implement programs with sufficient coverage and duration to make a difference.

Acevedo (2003) cites a World Bank study for Nicaragua (published in 2002) indicating that corn is the main importable crop in terms of share of GDP and the number of producers—141,000, of which 96,000 are farms of less than 10 *manzanas* (about 7 hectares or 17 acres). According to available data, the unit cost of Nicaraguan corn at the farm level is almost 9 percent higher than the cost, insurance, and freight price. Nonetheless, the imperfections of the domestic corn markets and the transaction costs are so great that a reduction in import tariffs would be highly unlikely to have an effect on the small-scale production of corn for self-consumption.

The main conclusion reached by Todd and others (2004) is that Central American countries should be willing to support the development of other nonagricultural activities that could absorb the peasants displaced as a result of CAFTA. The abiding question is whether the economies of Central America will have the capacity to create enough jobs to absorb a substantial number of peasants, given that unemployment and underemployment already affect tens of thousands of households.

Taylor (2002) reaches similar conclusions. He uses several scenarios to assess the impacts of the policy changes associated with trade liberalization in Central America and Mexico on households and the rural economy. He concludes that poor rural households do not benefit from trade liberalization because the imperfections and the high transaction costs associated with the local markets limit their access to financial markets and markets for nontraditional commercial products. Taylor predicts that international trade reforms are likely to aggravate rural poverty in this region. Without access to financial markets and markets for nontraditional products, the chief alternative for Central America's poor rural households will be to join the wage-earning workforce, including those outside their countries of origin.

Most of the models reviewed by Todd and others (2004), however, predict an improvement in poverty rates, especially with respect to changes in patterns of employment and migration. One substantial change is that numerous peasants will become wage workers in agriculture and other branches of the economy. But the authors sound a note of caution about their results, since a retrospective review of the ex ante analysis conducted for NAFTA suggests that actual effects tend to differ from those predicted by econometric specialists.

Chile. Chile is a party to 9 of the 33 agreements, conventions, and treaties affecting international trade registered in the Foreign Trade Information System (SICE) of the Organization of American States. Chile has signed FTAs with Canada, the United States, Mexico, Central America, the European Free Trade Association, the EU, and South Korea.

The Chilean economy is one of the most open to and integrated with international trade. Chile's exports plus imports account for 55 percent of its GDP and have been over 50 percent since the mid-1980s. Forestry and agriculture exports in 2004 were \$7.4 billion (25 percent more than in 2003), and imports were \$1.6 billion (15 percent more than in 2003). The share of

■ **TABLE 5.14 Forestry and Agricultural Exports in Chile's Foreign Trade, 1990–2004**

Millions of U.S. dollars, except where otherwise indicated

	1990	1995	2000	2004
Exports				
Total country	8,372.7	16,024.2	18,427.9	31,460.1
Forestry and agriculture	2,029.6	4,473.3	4,976.4	7,401.2
Share (percent)	24.2	27.9	27.0	23.5
Imports				
Total country	7,742.4	15,900.4	18,089.9	22,454.0
Forestry and agriculture	355.1	1,042.6	1,201.4	1,606.4
Share (percent)	4.6	6.6	6.6	7.2
Balance of trade				
Total country	630.3	123.8	338.0	9,006.1
Forestry and agriculture	1,674.5	3,430.7	3,774.9	5,794.8

Source: ODEPA (2005).

forestry and agricultural exports in total exports fluctuates at about 25 percent but has shown sustained growth for at least two decades (table 5.14).

Chile has also been successful in reducing poverty in general, and rural poverty in particular. Between 1990 and 2000, the rural poverty rate dropped from 40 percent to 24 percent, while extreme rural poverty fell from 15 percent to just 8 percent. Some regions in Chile have greatly benefited from liberalization and integration, specifically the agroexport areas in the center of the country, including the Libertador Bernardo O'Higgins region. Other areas in the center-south and south are best described as having been adversely affected, since their agriculture is geared toward the production of traditional products for internal consumption—the La Araucanía region is one example. Table 5.15 shows that the agroexport region (O'Higgins) cut its 2004 rural poverty rate to a mere 44 percent of the 1990 rate, while reducing extreme rural poverty to only 30 percent of its level 10 years earlier. On the other hand, the region that has been unable to enter the international market was only able to reduce its rural poverty and extreme rural poverty rates in 2000 to 77 percent and 59 percent, respectively, of their 1990 levels. This is a good example of the unequal distribution of the costs and benefits of economic liberalization and trade integration from one region to another.

As regards the participation of small producers in these processes, Chile is one of the countries in the region marked by great social deterioration among this sector of the population, as measured by the change in their poverty

■ **TABLE 5.15** Agricultural Exports and Rural Poverty in Two Regions of Chile

Indicator	Region	
	O'Higgins	Araucanía
Commercial orientation of agriculture	Export	Domestic
Forestry and agricultural exports (2004, \$US thousands)	1,007,891	318,000
Area used intensively in agriculture (ha)	266,000	370,000
Forestry and agricultural exports/area (\$/ha)	3,789	859
Rural poverty 1990 (%)	39.2	45.4
Extreme rural poverty 1990 (%)	12.9	23.2
Rural poverty 2000 (%)	17.2	34.9
Extreme rural poverty 2000 (%)	3.9	13.6
Rural poverty 2000/1990 (x 100)	44	77
Extreme rural poverty 2000/1990 (x 100)	30	59

Source: ODEPA (2005).

rate relative to the rural population in general. Given the country's general reduction of poverty, small rural producers have made slower progress than other rural social strata. Furthermore, this relative deterioration cannot be attributed to an absence of public policies for the development of small-scale agricultural production in Chile, since government investment targeting small farmers slightly exceeded \$2 billion between 1990 and 2004.

Liberalization, Growth, Inequality, and Poverty

After this detailed review of Latin America's experiences with liberalization, as well as relevant patterns of global commercial insertion and trends in poverty and inequality, a basic question that arises is, "To what extent has liberalization translated into higher growth rates, less inequality, and less poverty?" Some advocates use the argument that liberalization has had positive effects on these variables to defend integration processes.

Table 5.16 lists the countries in descending order of degree of economic liberalization. It shows that the region has experienced the most diverse outcomes when the extent of growth, income distribution, and poverty are compared. This corroborates the initial assertion that there is no simple, linear relationship between these variables. Paradoxically, Chile appears to be the only case where the alleged beneficial association occurs, with some

■ **TABLE 5.16** Correlations among Economic Liberalization, Growth, Income Distribution, and Poverty in Some Countries of Latin America

Country	Liberalization	Growth	Inequality	Poverty
Chile	high	high	unchanged ^d	decreased ^g
Costa Rica	high	moderate	increased ^b	decreased
Panama	high	moderate	decreased ^a	decreased
Venezuela	high	null	increased ^a	increased
Honduras	high	null	decreased ^e	decreased
Nicaragua	high	null	unchanged ^d	decreased
Brazil	low	low	increased ^b	decreased
Mexico	low ^h	low	decreased ^c	decreased
Bolivia	moderate	low	decreased ^a	increased
Guatemala	moderate	low	decreased ^e	decreased
El Salvador	moderate	moderate	increased ^b	decreased
Ecuador	moderate	null	increased ^a	increased ^g
Argentina	low	moderate	increased ^a	decreased ^f
Uruguay	low	moderate	decreased ^a	decreased
Peru	low	moderate	decreased ^d	increased
Colombia	low	null	decreased ^e	increased ^g
Paraguay	low	null	unchanged ^d	increased

Source: Based on ECLAC (2004a, 2004b).

Note: Liberalization: Measured as the ratio of exports plus imports to GDP. High is > average; low is < average.

Growth: Increase in per capita GDP: High > 4%; Moderate between 2% and 4%; low = 1% to 2%; null = 0% or negative.

Inequality: Gini index—^a urban only; ^b increased in both urban and rural areas; ^c decreased in urban areas but increased in rural areas; ^d increased in urban areas but decreased in rural areas; ^e decreased in both urban and rural areas.

Poverty: Changes from 1990 to 2002—^f increased 1999–2002; ^g decreased 1999–2002.

^h Mexico up to the early 1990s, before NAFTA.

qualifications. Approaches and models used for determining associations between economic liberalization and poverty should be examined to see how much they consider the experiences of the region since the 1990s, when all countries accelerated their integration processes.

5.3 Perspectives on the Social Impact of Integration and Liberalization

Without question, one of the areas in which the debate over economic policy has been particularly intense—even virulent, as revealed by the declarations

from Seattle in 1999—is the desirability of liberalization and, above all, the aptness of certain regional integration proposals, such as NAFTA and the FTAAs. The positions at the two extremes of this debate are highly charged ideologically. Some positions are based on the interests of certain sectors affected by integration, and others on the legitimate expectations created but left unsatisfied by these initiatives. Clearly, the fundamentalist positions of globophiles and globophobes contribute little to correcting the course of the process. Rather, there is a need for a study of the abundant literature generated in the 1990s on the social impact of liberalization.

The literature shows two generic types of approaches to determining the social impact of integration and liberalization. One is based on the application of various kinds of econometric models; the other involves simple estimates of changes that have occurred in certain relevant variables over a given period after implementation of the agreements. The first approach usually focuses on the impact of liberalization but is unable to determine the relative effect of the various trade agreements (the “spaghetti bowl”) to which each country is a party on wages, income distribution, and poverty. The second approach involves causal approximations of the impact of specific agreements on certain relevant variables.

The Models and Their Scope

A plethora of methods have been used to empirically decipher the relationship between trade and growth and, thereby, between trade, employment, wages, income distribution, and poverty. They include everything from cross-sectional studies and aggregate time series at the country level to diverse simulation methods that use partial and general equilibrium analyses. They all attempt to estimate the effect of the degree of economic liberalization on some aggregate measure of inequality or poverty.

One of the influential cross-sectional comparisons is the often-cited article by Dollar and Kraay (2001),¹¹ which compares the effect of liberalization on the per capita income of two groups of developing countries: the globalizers, which had experienced major increases in their trade from the 1980s onward (from 16 percent to 32 percent of GDP) and the nonglobalizers,

¹¹ Winters (2000), Anderson (2004), IDB (2002), Behrman and others (2001), Ravallion (2004), and Bhagwati and Srivanasan (n.d.), to mention a few.

for which trade fell (from 60 percent to 49 percent of GDP). The authors concluded that while the first group grew in the 1990s at rates of 5 percent per capita, the second group did so at an average pace of only 1.4 percent. They also concluded that, because there is no systematic relationship between changes in the volume of trade and changes in the inequality of income, the increases in the growth rates that accompanied the expansion of trade were translated into proportional increases in the income of the poor: “open approaches to trade lead to more rapid growth and to a reduction of poverty in poor countries.” Similar conclusions are reached by Bhagwati and Srinivasan (n.d.), McCulloch and others (2001), Winters (2000), Anderson (2004), and Sachs and Warner (1995).

Anderson (2004) indicates that the connection between liberalization and growth, though not unambiguous, is strong, and that there is no evidence that liberalization negatively affects growth. Anderson nonetheless stresses that the impact of liberalization can be diminished in the absence of free domestic markets, macroeconomic stability, sound institutions, and a reasonably developed infrastructure.

Bhagwati and Srinivasan (n.d.) fully support the conclusions of Dollar and Kraay that the countries where poverty has declined significantly have integrated more rapidly into the global economy. Hence they cannot agree with many of the critics who argue that free trade and foreign direct investment (FDI) are prejudicial to the poor.

Sachs and Warner (1995) analyze two sets of countries on the basis of their degree of liberalization in the period 1975–93. They conclude that in the second half of the twentieth century, the countries where economic growth was most rapid saw an increase in their exports (and imports) as a proportion of their economic activity as a whole. They add that, in most cases, the populations of those same countries experienced an improvement in their living standards.¹²

Winters (2000) and McCulloch and others (2001) take a more eclectic approach. They argue that given the existing empirical evidence, the fairest

¹² In subsequent work the authors underscore what they consider to be a surprising feature of modern economic growth: economies with abundant natural resources have tended to grow more slowly than those with shortages of natural resources. A clear negative correlation was seen between the rate of growth and the relative weight of natural resources in a country's exports. This reaffirms earlier points about the implications of global market entry patterns such as that of several countries in the region.

affirmation is that it has not been unequivocally demonstrated that trade liberalization per se promotes growth, but at the same time there is no evidence to argue that it harms growth.

These models conclude that liberalization tends to reduce poverty by increasing income without negative effects on income distribution. Some studies, including those by Dollar and Kraay, and by Bhagwati and Srinivasan, agree but with reservations. In fact, a series of studies with similar methodologies leads to opposite conclusions or qualifies the relationship with so many conditional factors as to strip the possible implications of all relevance.

Ravallion (2004), in examining these analyses, addresses the relationship between liberalization and poverty at the macro level (through cross-sectional studies and aggregate time series) and the micro level (using household-level data and case studies). He questions whether greater openness to foreign trade is the key to a rapid reduction of poverty or whether liberalization harms poor families more than it helps them—the generalizations promoted by both extremes of the globalization debate.

Ganuza and others (2001), using microsimulations, conclude that when the changes produced by liberalization are analyzed in terms of both inequality and poverty, the effects are positive for both in seven countries (Brazil, Chile, El Salvador, Guatemala, Jamaica, Panama, and Paraguay); distribution worsens and poverty increases in four (Argentina, Colombia, Peru, and Uruguay); poverty declines but inequality rises in five (Bolivia, Costa Rica, the Dominican Republic, Ecuador, and Mexico); and in one (Honduras) there is less inequality but greater poverty.

According to Behrman and others (2001), “the most significant results are: (i) that trade liberalization appears not to have had distinguishable effects on inequality and poverty in the region during the 1980s and 1990s; and (ii) that financial liberalization has had a significant effect on increasing inequality and poverty.” Studies on the impact of trade on wage inequality also show greater, less, or unaffected wage inequality depending on the periods studied, the method used, or the assumptions made, and lead to the conclusion that “there is no clear consensus regarding the long-term effects of trade liberalization on wage inequality; the various avenues of influence make it extremely difficult to detect the effects of trade on poverty” (IDB, 2002).

The foregoing suggests that our understanding of liberalization’s transmission mechanisms with respect to rural poverty is quite precarious, because of

a lack of information about trends in rural poverty and because the characteristics of the structural reform processes themselves, including liberalization, vary by country in terms of time and content. Indeed, the empirical evidence on the impact of such reforms includes early reforms where poverty grew and income distribution deteriorated, cases of poverty reductions without distributive effects, and cases where both phenomena showed positive signs. The same type of contrasts are also evident in economies where reforms were late in coming.

Birdsall and Londoño (1997) reach the following conclusions about the determinants of income increases for the poorest 20 percent of the population: (i) they are highly elastic with respect to economic growth, (ii) initial inequalities in the distribution of income have a negative effect two times greater than for the rest of the population, and (iii) income growth among the poor is highly dependent on the accumulation of capital in the economy.

There is no evidence of a simple, linear relationship between liberalization, changes in the distribution of income, and trends in poverty. To some extent, the actual causal flow from greater liberalization to greater growth and thus to a reduction in poverty has not been as automatic or as unidirectional as expected by those who promote liberalization as a policy. Rodrik (2003) is right to assert that “the evidence from the past two decades is very clear: the countries that grew most rapidly—starting in the mid 1970s—are those that invested a high percentage of their GDP while maintaining macroeconomic stability. *The relationship between growth and the indicators of the degree of liberalization—levels of tariff or nontariff barriers, or controls on the flow of capital—is weak, in the best of the cases*” (emphasis added).

Many of the econometric exercises have limitations. It is nonetheless interesting to note the series of works that Reimer (2002) has excellently gathered and summarized, because they indicate some progress with respect to the aggregate approaches of some of the studies mentioned above. Similar from a methodological viewpoint (partial equilibrium studies and simulations with general equilibrium models), these analyses incorporate the implications of various entry patterns of a part of the country’s population into the market, based on the hypothesis that their impact on poverty is mediated by differences in the population’s income sources.

The 11 partial equilibrium studies that include a cost-of-living analysis refer to Asia and Africa and emphasize the impact on food costs. The 18

simulation studies using general equilibrium models include a relatively old study on Latin America (Lysy and Taylor, 1980) that draws on data from Brazil and concludes that there are negative impacts on income distribution. This conclusion contrasts with that of Adelman and Robinson (1988), who indicate that the differences are derived from different definitions of income distribution (Reimer, 2002). In general, depending on the assumptions, several similar cases among those summarized reflect positive, neutral, or negative impacts on poverty or income distribution.

Hertel and others (1999) argue along the same lines as the general equilibrium studies summarized by Reimer. They examine the impact on poverty of the multilateral agreements in which Chile and Brazil were involved and distinguish among five occupational categories: (i) agricultural self-employment, (ii) nonagricultural self-employment, (iii) wage employment, (iv) diversified, and (v) recipients of transfers. If the liberalization action is multilateral, aggregate poverty decreases in Brazil and Chile over the short term. The greatest reduction corresponds to households specializing in agriculture as a consequence of greater profitability. There are also improvements, albeit smaller, for those who have diversified, but poverty increases for the other categories. Those involved in nonagricultural self-employment and wage employment benefit only when there is trade liberalization in the two countries and industrial protectionism elsewhere.

Notwithstanding the advances made in such studies, it is difficult to avoid concluding that several of the econometric exercises demonstrating unequivocal positive effects on growth and poverty reduction have an ideological agenda that influences the selection of assumptions, periods to be compared, countries to be included, and so on. Rodrik (2000) suggests as much in his critique of Dollar and Kraay,¹³ concluding that using the same information but correcting the “tricks,” the “globalizers” show less growth in the postliberalization years than in the 1970s.

¹³ Rodrik indicates that the authors combine a degree of politics with a given result, use different base years for calculating changes in tariffs and volumes, exclude countries that should have been included, and include other countries that do not meet the selection criteria. In an earlier work (Rodrik, 2000), he indicates that “authors in the openness-growth literature have used inappropriate indicators of trade policy, selected to systematically bias the results in favour of showing a statistically and quantitatively significant link between trade liberalization and growth.”

Models of the Regional Impacts of Globalization

With the exception of studies on Mexico and NAFTA, there have been few analyses of the differential impact of integration agreements on the interior regions of Latin American countries that are parties to those agreements. For Mexico, there is an initial study of the effect of joining the General Agreement on Tariffs and Trade (GATT) and then NAFTA on differential regional growth and employment, focusing on the growth lag of a group of southern Mexican states.

Aroca, Bosh, and Maloney (2003) analyze the geographic distribution of the growth rate before and after the country's accession to GATT in 1986. They use a spatial statistical technique and conclude that the impact of growth seems to be distributed in a random fashion throughout the territory, without a gradient that descends from north to south and culminates in Chiapas. Hence they reject the notion that NAFTA has held back the southern states (Oaxaca, Chiapas, and Veracruz).

The IDB (2002) takes a similar approach for two periods: Mexico's accession to GATT in 1986 and the creation of NAFTA in 1994. This study emphasizes the spatial trends of employment as opposed to income, observing that the most significant positive changes occurred in border towns such as Tijuana, Ciudad Juárez, and Mexicali. It concludes that integration probably helped lower regional inequalities along the highway linking the interior to the northern border, to the detriment of distant small cities and collective *ejido* farms. While liberalization could be identified as the immediate cause, the study points out that the main determinant of the trend is the preexisting infrastructure.

When Esquivel and others (2002) examine events since 1993, to some extent they arrive at similar conclusions: it is unclear whether liberalization and NAFTA have had direct negative effects, causing the states of the south to lag behind because they lacked the educational and infrastructure prerequisites for growth. The notion is reinforced by contrasting them with other states that, though far from the northern border, had significant growth rates over the specified time period.

Sánchez-Reaza and Rodríguez-Pose (2002) also explore the impact of growth disparities attributable to liberalization by contrasting the import substitution industrialization (ISI) period with events following Mexico's entry into GATT and NAFTA. Their conclusions differ significantly as regards the impact of liberalization. They apply a convergence analysis, which postulates

that areas sharing similar characteristics would tend to converge because those with lower income at the starting point would grow more rapidly than those with higher income. An examination of per capita growth in the period between 1970 and 1985—which corresponds to ISI—shows clear trends toward convergence; the period between the GATT and NAFTA, by contrast, shows profound changes in the spatial pattern of growth and increasing territorial polarization that continued to intensify with NAFTA. The authors therefore conclude that the most likely outcome of the intensification of NAFTA would be an increasing division between the “first world in the North, integrated into the economy of the United States, and the third world in the South, whose principal asset will consist of low labor costs.”

The convergence analysis shows how assumptions, methods of analysis, and the selection of the information used can lead to contradictory conclusions. These must all be carefully examined if they are to be used as a basis for designing strategies and policies.

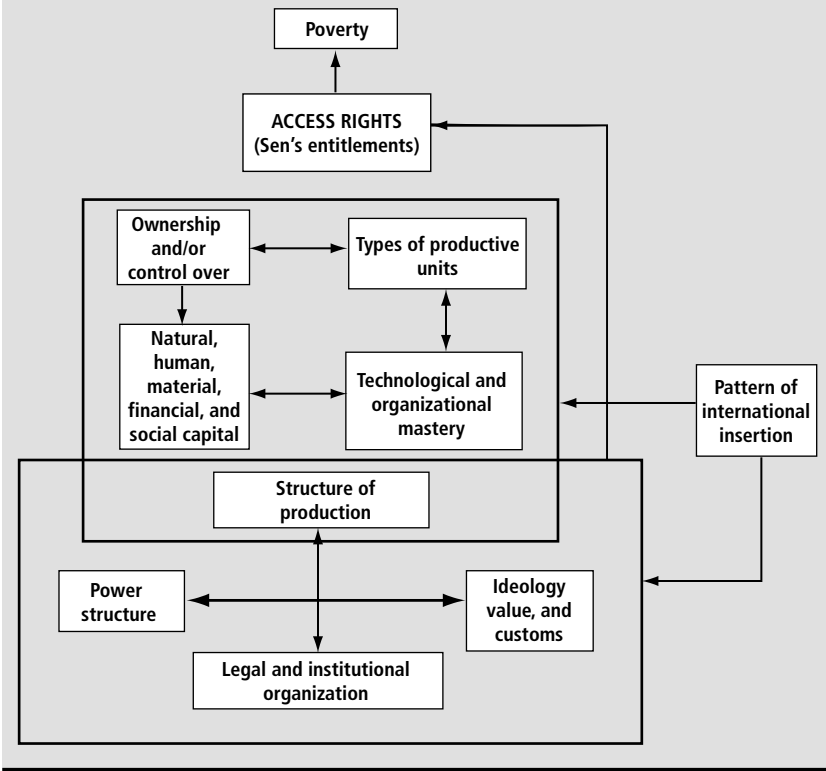
These assessments ultimately suggest that the effects of liberalization penetrate the economy through many pathways that include major idiosyncratic elements at any given time and in any given country and region. In each case, the most significant pathways leading to the households of the poorest families need to be reconstructed. Figure 5.17 illustrates the complexity of the pathways that link the integration of economies into international trade with poverty at the household or individual level.

An Alternative Approach

These approaches do not appear to be very useful as a basis for designing public policy, despite their rigor, their quality, or the contribution they might make to a better understanding of cause-and-effect relationships. Other avenues that shed more light on the connections between trade, growth, and rural social welfare could be useful in designing policy instruments to ensure beneficial relationships.

In a recent study, Rodrik (2003) indicates that many of the models associating trade with poverty reduction do so by connecting trade with production growth. These causal relationships are difficult to determine, since the converse can be based on identical arguments. Most endogenous growth models that attribute great benefits to liberalization use learning-curve effects and technological externalities that contribute to growth in productivity and income.

■ FIGURE 5.17 Relationship between Trade Liberalization and Poverty

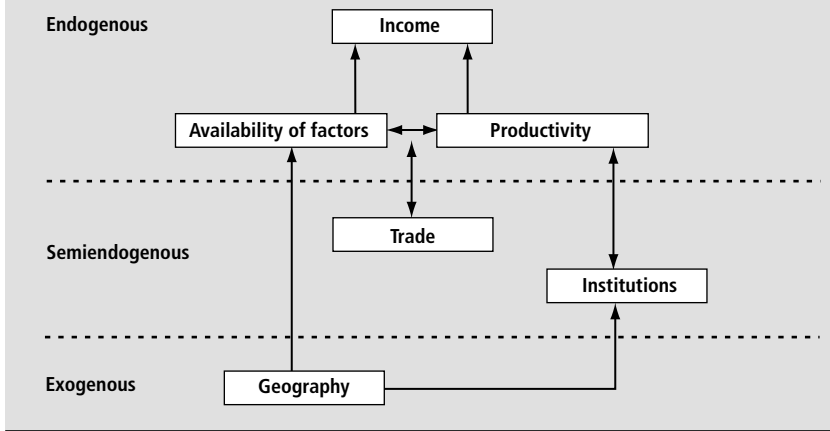


The author suggests taking the simplest model for determining income as the starting point, such as the one related to the availability of factors and their productivity. It should then incorporate geography as an exogenous element with an important effect on the availability of factors and on trade itself, because geography affects accessibility to markets and institutions (see figure 5.18). While quantifying this model is extremely complex, it allows for a more sophisticated and realistic policy orientation for the purpose of examining particular national cases.

This model emphasizes the reversible nature of cause-and-effect relationships. For example, Wei (2000) concludes that greater openness to trade creates higher-quality institutions, while Anderson and Marcuiller (1999) state that better institutions lead to the promotion of trade.

For Rodrik, the key question is to establish the most important vectors in the model in each case. The major debates in the literature on economic

■ **FIGURE 5.18** Conceptual Model of the Relationship between Trade and Income



Source: Based on Rodrik (2003).

growth and development can be seen as arguments about the relative strength of several of the arrows in figure 5.18. For example, those arguing for the primacy of geography emphasize the arrows leading from geography to income, by way of the availability of factors and productivity, pointing toward trade. Those who see global integration as a key element for growth emphasize the arrows leading from trade (by way of the availability of factors and productivity) toward income and institutions. The institutionalists emphasize the primacy of the institutions, arguing that increased trade and income result from improved institutions.

5.4 A New Approach to the Rural Sector

The design of rural development strategies and programs in a context of increasing liberalization requires adequate monitoring of the effects of greater exposure to exchanges with other countries or regions. Hence the need for a narrative description of national and local processes based on approaches such as those indicated above. This makes it possible to incorporate the contextual determinants of each particular situation and to identify the ways in which growing integration affects the lives and working conditions of the most vulnerable groups. It is important to consider the context in which rural development initiatives are proposed from the outset.

Contextual Factors Affecting Rural Development

In rural development, the critical mediating elements are unquestionably those arising from structural reforms. At a macro level, the globalization of trade and liberalization of capital markets, in a context where exports are considered to be the driving force for development, have accelerated the incorporation of national economies into the globalization process with all the implications this has for the autonomy of national economic policies.¹⁴

As regards the rural level, the following should be considered: (i) the transnationalization of food systems driven by the accelerated advance of supermarkets, (ii) changes in the structure of employment, (iii) the persistence of bimodality in the organization of production and the structural heterogeneity of family production units, and (iv) the faults of the government and the market. These factors lie behind the skewed nature of rural development, because the new conditions have been exploited by companies with land that have greater potential to produce viable exports, the capacity to obtain credit, access to technology, and information on internal and external market conditions. The benefits are therefore concentrated within certain products, regions, and types of medium-sized to large producers.

Changes in food systems. Developing countries' food systems have changed radically in recent decades as a result of globalization, urbanization, and the dissemination of technology. These changes are marked by several phenomena:

- A shift from production of commodities to production of food products with increasing degrees of added value and differentiation in the post-

¹⁴ It is undeniable that the contemporary version of trade liberalization displays qualitative differences compared with past phenomena. According to Castells (1999: 259), "what we have is an economy capable of working as a unit in real time on a planetary scale." International trade and capital markets are operating 24 hours a day at any distance thanks to information and communication technology. New supranational players are emerging or consolidating their influence, among them the World Trade Organization and multinational corporations, using new forms of organizing and coordinating production. The capacity of national governments to direct their own economies is limited by factors beyond their control, even when they are properly managing macroeconomic variables. Paradoxically, this underscores the need to strengthen the management capacity of subnational governments.

■ **TABLE 5.17** Different Market Entry Patterns of Small Agricultural Producers

Percentage of family units	Corn, Nicaragua	Beans, Nicaragua	Corn, Mexican <i>ejido</i> collective farms
Net buyers	23	28	27
Self-sufficient	30	30	32
Net sellers	39	37	28
Sellers and buyers	9	5	13

Source: De Janvry and Sadoulet (1999).

harvest phases, reflected in the fall of the relative market share of basic grains from 45 percent to 30 percent in two decades.

- Significant changes in the organizational aspects of processing and marketing throughout the value chains, and especially the accelerated growth of supermarkets, which compose the most visible element of this process and have become the main means of controlling and directing the dynamics of those systems.¹⁵
- Changes in how quality assurance and food safety standards and levels are determined—first in external markets and, increasingly, in internal markets as well.
- Institutional and management changes that affect contractual relations between providers and distributors, supported by the rapid incorporation of information and communication technologies that have and will continue to have significant effects on small producers as suppliers to the agrifood chains (see table 5.17 and Reardon and Timmer, 2005).

The social impact of these rural trends is far from uniform. To the extent that the development of supermarkets translates into lower prices for consumers (thanks to the significant reduction in transaction costs inherent in that strategy), rural consumers will benefit in midsized cities and even in small

¹⁵ The accelerated growth of supermarkets in the 1990s was driven by the liberalization of FDI, urbanization, and the inclusion of women in the labor market. Its manifestations are the rapid consolidation of trade in food, because of which the five major supermarket chains account for 60 to 80 percent of food sales, and the transnationalization of the principal agents, with a 56 percent market share (Reardon and Berdegue, 2002). Reardon and Berdegue (2002) examine supermarkets in Latin America in Argentina, Brazil, Chile, Costa Rica, and Mexico.

urban centers where the population goes to buy a significant part of its food in this type of entity. For small producers, the impact will depend on whether they are net buyers or net sellers. As net sellers (that is, potential providers of agricultural products to the supermarkets), small producers face trends that point toward producers capable of ensuring volume, quality, and regularity in delivery. Only a very small proportion of small rural producers are able to satisfy such conditions. Indeed, even if the price necessary to induce them to produce certain goods is less than the cost to agroindustry or supermarkets of producing them directly, the transaction costs involved in acquiring the goods from small producers essentially preclude the great majority of them from competing with larger-scale producers.

Changes in the structure of employment. Patterns of rural employment and the strategies adopted by rural families to generate income have changed significantly. The relative weight of nonagricultural rural employment in the employment of rural households grew in recent decades at an annual average rate of 4.3 percent, while agricultural employment per se decreased by 0.4 percent annually. If the agricultural employment of urban residents is included, it increased by 0.07 percent annually.

In absolute terms, the number of persons from rural households employed in the nonagricultural sectors increased by 2.5 million, while the number of members of rural households employed in agriculture declined by 933,000. Nonetheless, the number of agricultural workers with urban residences increased by 1.1 million. Thus the total number of rural plus urban inhabitants employed in agriculture registered a net increase of 200,000. In other words, the agricultural workforce became increasingly urbanized. This trend was especially acute in Chile (annual rate of 0.92 percent), Cuba (0.87 percent), Uruguay (0.73 percent), Brazil (0.55 percent), Ecuador (0.38 percent), and Panama (0.35 percent).

The income derived from nonagricultural rural employment averaged 47 percent of the total, with an occupational structure similar to that of urban jobs but with lower productivity levels and a greater relative weight on services. The most numerous and best opportunities for nonagricultural rural employment are concentrated in areas with a stronger agricultural dynamic. Furthermore, the households that were not poor found better-paid nonagricultural rural employment, although such work did in fact provide a major supplement to the income of the poorest households (Reardon and others, 2004).

This indicates that employment growth in the rural sector is no longer agricultural. Rural occupations are diversifying, and new activities in the sector, such as services and the transformation of primary products, are becoming an important part of the alternatives for labor. Consequently, the development of nonagricultural rural employment makes a positive contribution to reducing poverty, improving the quality of life of rural inhabitants and modernizing the agricultural sector. Nonetheless, the development of nonagricultural rural employment as a strategy to overcome poverty has limited effects. It requires productive development and certain economic dynamics to create stable jobs on a mass scale. It also assumes that multiple employment is accepted as the norm for a great majority of rural households and is part of rural development strategies.

Bimodality and Heterogeneity

Most of these countries share a legacy of the transition from the hacienda model to the corporate agricultural model in the presence of bimodal structures in agriculture. In rural areas, agricultural and nonagricultural enterprises of a corporate nature coexist with many small family units of the peasant type.

The empirical evidence and some theoretical underpinnings make it possible to say that there are great differences in the “internal logic of management”—that is, the criteria by which one unit or another makes decisions about what, how much, how, and for whom to produce. These decisions are very important in analyzing the impact of integration and designing incentives, strategies, or policies that could influence the sector’s behavior and development.

Table 5.18 schematizes the contrasts in behavior between different organizational forms. These are not examined individually here, but the relative differences in the nature of the workforce and the manner of internalizing risk should be highlighted. The nature of the workforce helps determine the competitive potential of the family units for labor-intensive products. The way risks are internalized is important because it affects the willingness of such units to undertake new enterprises.¹⁶

¹⁶ For the theoretical foundation of this assertion, see Schejtman (1980) and Figueroa (1981).

■ **TABLE 5.18** Contrasts between Micro- and Small Agricultural Family Enterprises and Medium-Sized to Large Agricultural Companies

Attributes	Peasant agriculture	Corporate agriculture
Objective of production	Continuation of the family and production unit.	Maximize the rate of return and the accumulation of capital.
Origin of workforce	Fundamentally family and, on occasion, reciprocal exchange with other units.	Wage labor.
Commitment of the head of production to the labor force	Absolute.	Absent, except as legally obligated.
Technology	High intensity of labor, low density of "capital" and of inputs bought per workday.	Greater density of capital per asset and greater proportion of purchased inputs in the price of the final product.
Destination of products and origin of inputs	Partially commercial.	Commercial.
Criteria for intensification of work	Maximum total product, even at the cost of a decline in the mean product. Limit: marginal product of zero.	Marginal productivity > wages.
Risk and uncertainty	Nonprobabilistic evasion: "algorithm of survival."	Probabilistic internalization, seeking return proportional to risk.
Character of workforce	Nontransferable, internalized marginal cost.	Only employs a workforce that is transferable as a function of skill.
Components of net income or product	Indivisible family product or income, partially paid in kind.	Salary, income, and earnings that are exclusively monetary.

Source: Schejtman (1980).

The existence of some nontransferable marginal labor in family agriculture indicates that this resource (for example, the work of women and children or other nonremunerated family members, or the "free" time of the head of household) can create value only within that structure. In other words, no other entity values that available work time. By contrast, a capitalist company depends on wage labor, which it seeks in the market.

Management criteria incorporate risk considerations differently. An entrepreneur may choose a riskier alternative if the expected gain is greater, whereas a small producer will tend to avoid the higher-risk alternative, no matter how large the potential income, if a negative result would threaten his family's sustenance and ability to produce.

These contrasts in “management logic” imply that liberalization will affect different types of units differently. To simplify, the impact of liberalization on the principal macroeconomic prices (interest rates, exchange rate, wages), as well as on the relative prices of goods and services, can provoke responses that vary by circumstance and that can be polar opposites in certain cases. For example, the models predicted that NAFTA could result in a massive drop in corn production in Mexico. This did not happen: peasant units expanded the cultivated area (De Janvry and others, 1995; Taylor and others, 2003).

In addition to structural bimodality, the small family unit sector itself is very heterogeneous. Indeed, processes of differentiation have created many patterns of interaction between small family units and the economy, ranging from the sale of one’s labor to the sale of production that sometimes can generate a certain cumulative surplus. Every possible intermediate situation is also represented. To take this variability into account, typologies of producers or rural family units have been formulated in almost all of the countries in an effort to design distinct policies. Furthermore, certain econometric models for estimating the impact of liberalization include considerations of the families’ labor market, so as to distinguish between the effects of liberalization.¹⁷

In addition to a bimodal agrarian structure and heterogeneous micro and small-family peasant enterprises, markets are also heterogeneous. Agricultural activity in general, and that of small producers in particular, operates in a realm where the behavior of the markets for loans, insurance, technology, information, and so on is far from the Walrasian ideal. This results in institutional relationships among agents whose peculiarities distinguish them from the more formal mechanisms of these markets and yields idiosyncratic communications and relationships between family producers and other agents outside the open market.

Credit. While basic grains can be cultivated with an input intensity consistent with the financial means of a peasant family, commodities almost always demand outlays for inputs and even additional labor far exceeding the cash assets of the family unit. This raises a formidable barrier to the adaptation of

¹⁷ Coxhead and Warr (1995), Lysy and Taylor (1980), and Harrison and others (2000).

existing agrofood systems to products of greater value,¹⁸ even if their production would more than justify the credit required.

Insurance. Nontraditional crops generally entail greater risks than traditional crops because the direct costs are higher and because the fluctuations in prices (and often in yields) are greater. In the absence of insurance alternatives, small producers protect themselves against the possibility of adverse consequences in various ways: selling assets (livestock), leasing out land, diversifying crops, opting for crops that bring less income but that are less subject to volatility, working off the farm, emigrating, making agreements with buyers, and so forth.

Information. Access to information is a requirement for entering and staying in the nontraditional products market. Such access is often confined to large companies, generally agribusiness or agroindustrial firms, and involves acquisition costs that are generally beyond the reach of small producers or even their cooperatives, with few exceptions.

Technology and specialized inputs. The markets for several of the inputs or services used for nontraditional crops are generally too narrow. Small producers generally have to access them through an agreement or association with an agroindustrial or agribusiness firm.

Land. This market continues to exhibit great rigidity in matching demand to supply, even in countries that have undertaken agrarian reform. Moreover, agricultural land prices only partially reflect the land's potential as a productive input, a circumstance that distinguishes land from other production inputs. One consequence of this is to reduce the viability of redistribution processes in favor of small producers via the market.

Labor. The specificities of the rural labor market keep it from fitting into a neoclassical model. Wages are higher for similar activities in urban settings for a variety of reasons. These include isolation or dispersion with respect to the means of transportation, which limits mobility; the seasonal nature of

¹⁸ The cost per hectare of many nontraditional crops can be 10 or more times higher than for basic grains.

agricultural activity, which requires flexibility; certain forms of intermediation (subcontracting agents) that undermine the transparency of the remuneration received; lack of information on existing opportunities; and so forth.

Proposal: Territorial Rural Development

Considering the empirical phenomena and the contextual determinants of rural development, the present authors prefer an alternative that is less formally elegant than many of the econometric models cited herein, but that is more consistent with the diverse situations that complicate the development of a conceptual framework for delineating elements of a liberalization policy that will include the rural poor.¹⁹

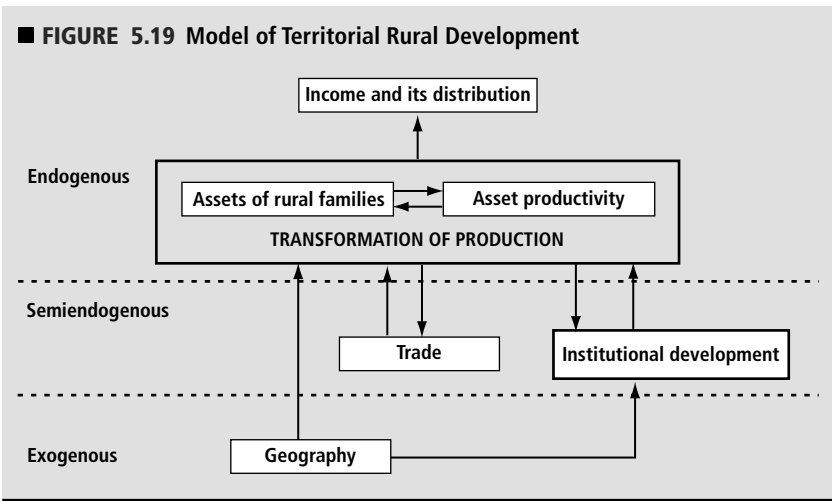
Assuming greater openness to foreign trade, the question would be: “Under what conditions or contexts can relationships between liberalization and rural poverty be examined in such a way as to reveal the paths of mediation leading to the exclusion or inclusion of poor rural families?” And as a corollary: “What are the guiding policy criteria derived from these answers?”

The asymmetrical regional impact of integration makes the national scale too aggregated a level for exploring these issues. The analysis should be undertaken at a subnational level, to the extent that local differences in productive structures and institutional arrangements determine the impact of liberalization on the welfare of rural populations.

Rodrik’s simple model thus seems promising for developing narratives of particular examples of the relationship between trade, growth, income distribution, and poverty. It allows for local idiosyncrasies to be incorporated and better policy options to be devised, to the extent that such an approach can coherently link two crucially important elements (figure 5.19):

- *Productive transformation* processes enable rural territories to be linked to dynamic markets and, in the case at hand, to markets that become more accessible with increased economic liberalization and trade integration.
- *Institutional change* appears indispensable to effectively transforming production and being more inclusive of the poor.

¹⁹ This section is based on Schejtman and Berdegué (2004).



Source: Based on Rodrik (2003).

The liberalization and integration processes must explicitly work toward producing greater social welfare. Indeed, the foregoing analyses clearly demonstrate that it is unreasonable to assume that such welfare will automatically result from all liberalization processes. Rather, it must be actively included in policy designs. Rural development that is territorial in nature can help liberalization and integration processes improve the welfare of poor rural populations.

Territorial rural development is a process of transforming production and institutions in a given rural area, in an attempt to reduce rural poverty. The transformation of production aims to competitively and sustainably connect a territory's economy with dynamic markets. Institutional development aims to encourage and facilitate interaction and consensus building among local players and between them and relevant external agents. It also seeks to increase opportunities for the poor to participate in the process and its benefits.

Territorial rural development policies and programs must include the following operational criteria, which are necessary to strengthen the relationship between liberalization and integration, growth, and rural social welfare.

Criterion 1. The transformation of production and institutional development must take place simultaneously. They interact with one another, and both are necessary to achieve significant, sustainable reductions in rural poverty based on economic liberalization and integration processes.

Criterion 2. Territorial rural development programs must operate with a broad concept of “rural,” which must necessarily include any urban areas with which the poor areas have or could have functional ties in terms of production or social matters.

Criterion 3. Such programs must consider all possible routes to overcoming rural poverty: agriculture, nonagricultural rural employment, migration and combinations thereof, or multiple employment.

Criterion 4. Territorial rural development assumes a social identity paradigm and a development program that enjoys social consensus. Without these, rural territories, and in particular the poorest of such territories, cannot be involved in liberalization and integration processes in any beneficial way.

Criterion 5. Territorial rural development programs must explicitly consider the heterogeneity of territories or regions, and must also expressly address the problem of the regionally distinct impacts of liberalization and integration.

Criterion 6. These programs must bring together the many different agents of the territory. Poor rural sectors can develop certain capacities and competencies on the basis of their own organization. Nonetheless, the poor can access other determinants of development only through ties to other economic and social agents. Hence the forging of such links—that is, the promotion of a social consensus—is crucial for territorial rural development.

Criterion 7. The programs require a complex institutional architecture that includes institutions for mediation between the state, the market, and civil society, and that is marked by several elements: the attributes and capacities of the local governments in their technical, administrative, and political dimensions; the existence and coordination of checks and balances between the national, provincial, and local levels of government; networks and other forms of association among local governments so as to create regional organizations capable of transforming production; economic organizations and representatives of civil society; and channels and mechanisms for public-private consensus building at levels and scales appropriate for territorial rural development.

Criterion 8. Territorial rural development programs must be devised and managed with mid- to long-term horizons. Various agents can assess different time frames for territorial rural development in extremely variable if not contradictory ways. Technical specialists and agencies are accustomed to operating with horizons of about five years, in which period they can envisage the processes that are essential in the framework of their disciplines. For them, relevant actions are those that produce results that can be assessed within that time frame. For politicians, time frames are determined by electoral cycles, which tend to be two to four years at local levels. They expect to be able to show achievements during their terms of office, a circumstance that influences their selection of the actions they advocate. For the people living in the territory, time frames are shorter as needs become more acute. The time required to overcome the fundamental situation, however, exceeds the time frames of technical specialists and politicians.

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Economic Integration, Growth, and Poverty: Prospects for the Colombia–U.S. Free Trade Agreement

Xavier Sala-i-Martin

During the last three decades the world has seen poverty rates fall by about two-thirds, and growth and global individual inequality drop, perhaps for the first time in history (Sala-i-Martin, 2006). At the same time, international trade has increased by more than 60 percent. Regional trade agreements (RTAs) have played a major role in this: 40 percent of trade occurs within RTAs. In the early 1980s, only five RTAs had been reported to the World Trade Organization (WTO). Today, there over 200 agreements and another 60 are being negotiated.

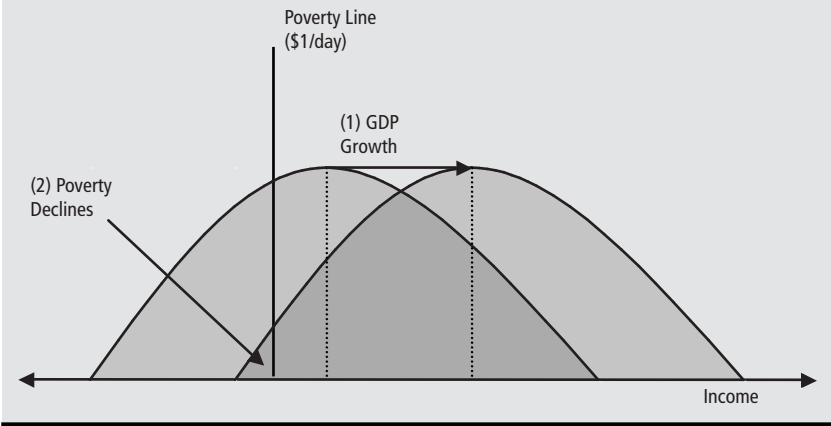
This chapter argues that poverty reduction, economic growth, and economic integration are, indeed, related phenomena. We review the theoretical mechanisms through which trade boosts growth, reduces poverty, and increases the incomes of the disadvantaged and analyze the empirical evidence that supports these claims.

6.1 Openness, Growth, Inequality, and Poverty

It is widely agreed that the best way for a country to reduce poverty rates is to grow. Growth of per capita gross domestic product (GDP) shifts the mean of the income distribution to the right (as seen in figure 6.1a).

If the dispersion (or inequality) of the distribution does not change, the area under the distribution and to the left of a particular poverty line (say, the one-dollar-a-day line), which corresponds to the poverty rate, automatically declines. Poverty can also decrease if, for a given mean income, the dispersion of the distribution (the inequality) declines, as seen in figure 6.1b. Conversely, for a given mean, poverty increases when inequality increases. The only way for a country with potential growth to experience an increase in poverty is

■ FIGURE 6.1a Growth Leads to Decline in Poverty

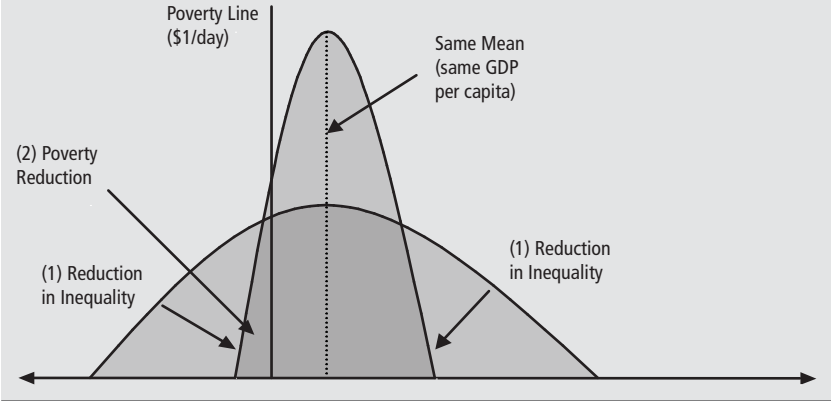


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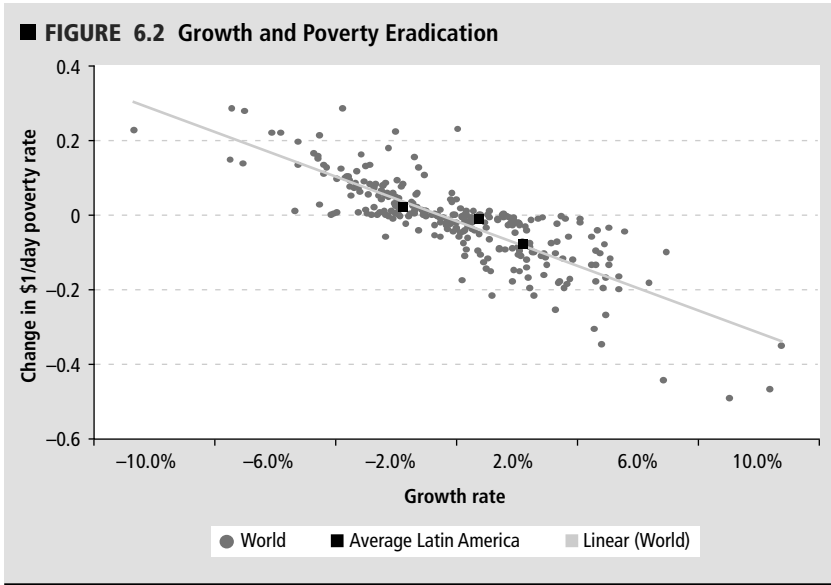
for inequality to increase. In other words, if positive growth rates did not systematically increase the incomes of the poor, then we would find a systematic association between positive growth and increased income inequality.

But empirical literature has failed to find such an association (see Barro, 2000). It follows that, on average, growth is good for the poor. Deininger and Squire (1996) show that in 88 percent of the growth episodes around the world, the income of the poor increased. Using household data from surveys

■ FIGURE 6.1b Reduction in Inequality Leads to Decline in Poverty



Source: Author.



Source: Author's calculations.

in 42 countries, Ravallion and Chen (1997) find that aggregate income growth reduced poverty. Dollar and Kraay (2001a) use a large panel of 137 developing countries to show that the income of the poorest quintile tends to grow *one for one* with per capita income.¹

To document the empirical correlation between growth and poverty eradication, figure 6.2 plots the decadal change in \$1/day poverty rates as measured by Sala-i-Martin (2006) and the corresponding annual growth rate during the same decade. That is, for each country we estimate the change in one-dollar-a-day poverty rates between 1970 and 1980, between 1980 and 1990, and between 1990 and 2000, and we compute the annual growth rate during the same decade. Figure 6.2 presents the scatter plot of these two variables. We see that countries that reduce poverty the fastest are those that

¹ The case of China has been put forth as an example of growth being associated with enormous increases in inequality. The Gini coefficient in China did indeed increase from 0.32 to 0.38 between 1980 and 2000. But this increase was not large enough to offset the beneficial effects of aggregate growth (Quah, 2002). In fact, poverty rates in China have declined from 27 percent in 1980 to 3 percent today. Thanks to growth rates of 10 percent per year, over 250 million people have escaped poverty in China (Sala-i-Martin, 2006). Hence, although China is an example of growth being associated with inequality, it is not an example of growth not reducing poverty.

grow the most. In fact, according to the data used to construct this figure, an increase in growth of 1 percentage point leads to a reduction in poverty rates of about 3 percentage points. Overall, aggregate growth explains up to 63 percent of the variability in poverty rates.

Latin America is not an exception to the rule that the larger the growth rate, the faster poverty rates fall. In the figure, black squares display the three observations for the average growth in Latin America and the average poverty reduction in the region during the same decade. We see that they line up quite well along the regression line.

The finding that growth tends to reduce poverty applies both when the source of growth is economic trade and integration and when it is some other alternative factor as well. As Berg and Krueger (2003) put it: “Growth associated with trade openness is as propoor as growth in general.” Berg and Krueger add that “since within-country inequality does not systematically increase with trade, we can say that openness also reduces poverty.”

Openness and Inequality

Figures 6.1a and 6.1b suggest that if we want to estimate the effects of openness on poverty, we need to study its effects on inequality and its effects on growth.

Recent empirical evidence (Sala-i-Martin, 2006) suggests that within-country inequality has increased over the last 30 years.² Trade liberalization has occurred in a more or less generalized fashion all over the world. Hence, some analysts conclude that openness and globalization have triggered an explosion of greater income inequality.

Although there may be some truth to this argument, we must not forget that trade globalization has not been the only phenomenon to occur in the world during the last 30 years. For example, the computer and information technology revolution is skill biased. That is, it tends to increase the demand for those workers with higher education and skills, thereby increasing wage inequality.

² Global individual inequality, on the other hand, has declined, as the incomes of the majority of the world's poor (that is, the citizens of Asia) have grown faster than the incomes of the rich. This process of cross-country individual income convergence has more than offset the increases in within-country inequality so that overall dispersion has declined since 1970.

How has trade impacted overall levels of inequality? Traditional trade theory (Heckscher-Ohlin and Stolper-Samuelson) suggests that in less-developed economies (which tend to have relatively more abundant labor), trade with developed countries will raise the price of labor-intensive goods and allow specialization in labor-intensive sectors, which in turn will increase the remuneration of workers.³ In other words, traditional trade theory suggests that trade liberalization should bring lower, not higher, levels of income and wage inequality.

Goldberg and Pavcnik (2004, 2007) argue that “this increase in the skill premium in many developing countries (and in Latin America in particular) is consistent with the Stolper-Samuelson theorem because unskilled-labor-intensive sectors were protected with the highest tariffs prior to trade reform and experienced the largest tariff reductions during trade reform.” These protection patterns have been reported for Colombia (Attanasio and others, 2004), Mexico (Hanson and Harrison, 1999; Robertson, 2000, 2004 for pre-NAFTA period), Morocco (Currie and Harrison, 1997), and Brazil (Pavcnik and others, 2004).

Another possibility is that labor-market rigidities do not allow for the cross-sectoral labor reallocation needed for this theory to work. A common finding of studies of trade liberalization in developing countries is the lack of such reallocation. For example, Attanasio and others (2004) find that, for Colombia, a regression of industry employment shares of industry tariffs (holding constant other important factors) yields a tariff coefficient that is small in magnitude and statistically insignificant. The same phenomenon has been noted in other developing countries: Revenga (1997), Hanson and Harrison (1999), and Feliciano (2001) for Mexico, Currie and Harrison (1997) for Morocco, and Wacziarg and Seddon Wallack (2004) in a cross-country study of trade liberalization. All these studies attribute the lack of labor reallocation to “either rigid labor markets (so that the adjustment to trade liberalization occurs through relative wage adjustments (Colombia, Mexico), or to the existence of imperfect product markets (so that firms respond by lowering of profit margins [Mexico, Morocco] and not through labor reallocation across sectors)” (Goldberg and Pavcnik, 2004, 2007).

³ If the labor supply is horizontal (which will probably be the case if there is a large pool of rural workers ready to migrate and take jobs in newly created industries), then trade will tend to generate employment in the labor-intensive sector. Whether it is through an increase in wages or an expansion of employment opportunities, trade will tend to reduce poverty in the traditional models.

A third possibility is that the traditional models are incomplete. For example, Acemoglu (2003) argues that trade liberalization may lead to increased trade in machinery and other technologically advanced goods that are complementary to skilled labor, thereby increasing the relative demand for educated and trained workers. In this case, trade would lead to more wage dispersion. There is some supporting evidence for this view. Attanasio and others (2004) regress the *change* in the share of skilled workers in each sector to the *change* in tariff protection over the period 1984–98. The increase in demand for skilled workers was largest in those sectors that experienced the largest tariff cuts (for example, textiles and apparel).

A fourth possibility is that trade liberalization may come with capital account liberalization, which introduces a great deal of exchange rate uncertainty. To protect against this uncertainty, firms may have incentives to upgrade the product mix and increase the quality of their domestic plants, which may further contribute to the widening of the wage gap (Goldberg and Pavcnik, 2007).

Similarly, Aghion and others (2003) construct a model in which different companies are at varying distances from the “technological frontier.” In response to trade liberalization, firms that are closer to the technological frontier survive while those that are technologically backward tend to disappear due to increased competition. The average effect of trade liberalization, then, depends on the fraction of firms that are close to the frontier. These authors look at the Indian evidence after the 1991 liberalization and find that productivity and profits increased in those sectors that were close to the technological frontier.

The overall impact of trade liberalization is very hard to isolate at the economy-wide, industry-wide, and firm level. Goldberg and Pavcnik (2007) survey the empirical literature and find little evidence of the impact of trade on overall inequality. They find some impact of trade on increased industry-level wage inequality, but the effects tend to be small relative to the observed movements: “Given the magnitude of the trade reforms, the effects uncovered by empirical work are small, and can explain only a small fraction of the general increase in wage inequality.”

Openness and Growth

If trade does not really cause increases in inequality, then its impact (positive or negative) on poverty must come from its effect on growth. Here, again,

traditional trade models (of the Heckscher-Ohlin type) are incomplete in the sense that they do not really try to describe the effects of trade on growth. Among other things, they do not account for economies of scale, differences in technology, and capital mobility, and they assume that institutions and policies remain unchanged as economies integrate. Modern economic analysis includes these dynamic factors and concludes that economic integration will tend to have an impact on the rate of economic growth. Economists believe that the main reason why openness is good for the economy has little to do with the traditional static gains from trade. The main channel through which openness increases welfare is by the increased aggregate growth rate. Summers (1991) puts it forcefully: "To the chagrin of economists, the real gains from trade policies of any kind cannot, with the possible exception of agriculture, lie in the triangles and welfare measures we are so good at calculating. Instead, they can be found in the salutary effects of competition and openness on domestic policy more generally . . . including the political and symbolic benefits that it can bring in promoting domestic reform, solidifying ties between neighbors, and more fully harmonizing other aspects of national policies."

The channels through which integration can affect the overall growth rate of the economy are numerous:

- *Increased specialization* according to comparative advantage. This is the channel emphasized by Adam Smith and the economists of the eighteenth and nineteenth centuries.
- *Greater exploitation of increasing returns*. Firms can increase their productivity when their markets are larger because they can better exploit economies of scale. Related to this we have the existence of agglomeration effects from location choice. Krugman and Venables (1990) study the effects of integration on location choice, by analyzing how integration gives industries strong incentives to move to central regions (Krugman, 1991; Venables, 1996; Fujita and others, 1999; Baldwin and others, 2003). RTAs may increase the incentives for industry to locate in member countries rather than going to nonmember countries. This also tends to have beneficial effects on related industries through supply chains (Schiff and Winters, 2003).
- Venables and Winters (2004) estimate that the 1992 European integration led to a large intraindustry reorganization, which led to larger firms, whose

larger size led to more efficient production. They believe that similar gains could occur in Latin America if it finally decides to integrate, although these gains will occur only if (as was the case in Europe) the differences in regulations are also eliminated. Otherwise, markets will continue to be segmented and the gains from increasing returns will not be realized.

- *Importing ideas*, knowledge, and technological capacities, including benefits from the acceleration of learning and the larger variety of technological inputs. All this tends to increase factor productivity and, as a result, economic growth. Using comparative data for 93 countries, Edwards (1998) shows that openness brings faster productivity growth. This result is robust to changes in the openness indicator, estimation technique, time period, and functional forms. Coe and others (1997) find that “total productivity in a panel of 71 developing countries is significantly related to the stock of research and development carried out by trading partners.” Coe and Helpman (1995), Keller (2002), and Romalis (2007) also report new evidence based on instrumental variable techniques.
- Positive effects of *increased competition* on productivity. This is what Leibenstein (1966) called “x-efficiency”—the increased efficiency that arises when firms face competition. That is, larger competition from foreign firms pressures local producers to increase their efficiency and upgrade the productivity of their resource use. There is a vast literature highlighting the positive effect of opening on productivity through reallocation across firms within industries (see, for example, Goldberg and Pavcnik, 2001).
- *Larger availability of capital* through foreign direct investment (FDI). It is widely believed that trade partners tend to affect the amount of FDI. At a theoretical level, the direction is not clear: horizontal FDI (setting up a replica plant in a foreign country) may decrease trade because trade is a good substitute for local production in the foreign country. Vertical FDI (sending part of the company to produce components to be traded back to the headquarters), on the other hand, may increase trade as corporations attempt to produce each of the components in the country in which the costs are smallest and then take advantage of the low trading costs of the free trade agreement (FTA) to send the various inputs back and forth. Which of the two effects dominates in practice? Levy-Yeyati and others (2004) attempt to disentangle the two effects empirically. They find that, indeed, horizontal FDI declines when countries sign an FTA and

vertical FDI increases. The increase in vertical FDI tends to more than offset the decline of vertical FDI so that the overall effect of an FTA on FDI is positive and large. Being part of an FTA leads to an overall increase in FDI of about 27 percent. See Blomstrom and Kokko (1997).

- *Technological progress.* Of course one of the benefits of increased FDI is a larger availability of capital. Another, perhaps more important effect is the larger availability of technology, as firms that move across borders tend to transfer their technology to the target country. In particular, one kind of technology that matters for trade is transaction technology. Transaction costs are usually ignored from theory but they tend to be very large in practice: shipping costs, refrigeration technologies, and inventory management are just some examples. This kind of technological progress in trade may lead to a “virtuous trade circle” through which opening up for trade increases the efficiency of trade, which in turn leads to even more trade. See Hummels and Skiba (2004) for a further development of this argument.
- *Openness,* to which economists pay the least attention, perhaps has the greatest economic impact due to its positive effect on institutions, policies, and the political process itself. For example, economic integration leads to coordination of banking regulations, transportation, and energy networks. By seeing how their neighbors operate, locals can improve their social attitudes toward the economy and work in ways that enhance their overall economic performance. Integration also helps lock in domestic reforms. Other advantages relate to feasibility and reciprocity.

Venables and Winters (2004) argue that the direct gains from trade for European Union (EU) members pale in comparison with the political and institutional gains obtained from the EU. In fact, they even argue that the EU was founded not on the calculations of costs and benefits of freer trade or more flexible capital and labor mobility but on the political and institutional gains through the cohesion of a war-torn continent.

The institutional environment that is best for each particular country is different. Throughout history we have witnessed failure after failure when foreign forces (from colonial powers to international financial institutions to superpowers) have attempted to “impose” the “right” institutions on less-developed countries. Countries need to find the right institutional framework in the context of the history and culture of the country through trial

and error. The “trial” part of the equation, however, can be improved when countries are open to the ideas experimented with by neighboring countries that are similar in nature. By adapting what has worked elsewhere (especially if elsewhere is a region with similar historical and cultural background to their own reality), countries may find interesting ways to improve their own institutional environment and, as a result, find their way to faster growth and development paths.

Southern European countries that joined the EU late have witnessed dramatic institutional transformation by way of intelligent adaptation of what has worked in more-advanced countries of the EU. This has allowed the newcomers to converge more rapidly than would otherwise have been possible.

Finally, if leading rich countries do not open up to less-developed countries, there is a risk that the citizens of the poor economy will feel “left out” of the globalization process. When this happens, they are likely to vote for protectionist, populist, and narrow-minded nationalist political leaders who end up implementing policies that reduce the growth prospects of the country.

In sum, there are many theoretical arguments that suggest that openness tends to generate economic growth. True, theory does not predict a simple relationship between exposure to trade and economic growth, but there is a strong presumption in favor of the proposition that international trade and open trade policies are major contributing factors for growth. This presumption partly comes from theory but it becomes a lot stronger when we evaluate the empirical evidence.

Before we turn to the empirical evidence, however, let us briefly mention the debate on how to go about opening up the economy: unilateralism, multilateralism, and RTAs.

Unilateralism, Multilateralism, and RTAs

The leading theorist of free trade in modern times, Jagdish Bhagwati, argues that the best way to open up an economy is through multilateral nondiscriminatory trade liberalization under the most-favored-nation (MFN) clause (Bhagwati, 1998). In the absence of multilateral agreements, unilateral policies to open up the economy are the second most desirable. As Joan Robinson puts it: “Even if your neighbor wants to throw rocks in his harbor it is not a good idea for

you to do the same thing.” That is, lower tariffs are good for you (because they allow your citizens to purchase goods at lower prices) even if your neighbors have them. This is especially true for developing countries because they tend to purchase capital goods abroad. Hence, tariffs will tend to make investment more expensive and, as a result, reduce the aggregate growth rate of the economy.

If multilateral and unilateral trade agreements are amply viewed as good, there is less consensus on the desirability of RTAs. In fact, theorists who favor free trade, such as Bhagwati, say that not only may RTAs not be beneficial, but they can even be detrimental.⁴ The main reason for this is what Viner (1950) called “trade diversion”:⁵ when a country applies the same tariff to all nations, it will always import from the most efficient producer who supplies the goods at the lowest price. When establishing an FTA with a nation that is not the most efficient producer, we may end up buying from this new partner at the expense of the low-cost producer, who does not benefit from the tariff reduction. That “trade diversion” would be harmful for the economy.

Although this is a theoretical possibility, the question is whether in practice trade diversion occurs and, if it does, whether it more than offsets the beneficial consequences of integration described in previous chapters. Empirical analysis conducted by the World Bank (2005) suggests that RTAs have indeed diverted trade, but seem to have created more trade than they have diverted. The trade diversion argument seems to be especially strong for RTAs among rich countries (such as in the EU) or among poor countries (Southern Common Market). RTAs that involve rich and poor (or North and South) nations tend to be trade creating (see Venables, 2001).

Former U.S. Treasury Secretary Lawrence Summers (1991) is convinced that trade diversion, although theoretically possible, is not a serious issue in

⁴ The World Bank (2005) estimates that a global trade reform in which all distortions are eliminated (full liberalization of agriculture included) could increase world income by \$263 billion in 2015 (\$109 billion would go to poor countries). Instead, if all developing countries had bilateral agreements with the European Union, United States, Canada, and Japan, global income would rise by only \$112 billion, and the rich would reap as much as \$133 billion.

⁵ On top of trade diversion, Bhagwati puts forth additional arguments against RTAs that have to do with the political economy of multilateral agreements: the “stumbling blocks” argument suggests that countries that already belong to an RTA have fewer incentives to go all the way to the multilateral agreements. He also argues that a constellation of RTAs resembles a “spaghetti bowl” of rules and regulations that unnecessarily complicate trade and international relations.

practice: “Economists should maintain a strong, but rebuttable, presumption in favor of all lateral reductions in trade barriers, whether they be multi, uni, bi, tri, plurilateral. Global liberalization may be best, but regional liberalization is very likely to be good.” Given the existing structure of trade, Summers writes, “Plausible regional arrangements are likely to have trade creating effects that exceed their trade diverting effects and that there is a very good chance that even trade diverting regional arrangements will increase welfare.”

Venables (2003) agrees with this position. He writes that while there is little evidence that RTAs between two developed countries stimulate growth, there is ample evidence that RTAs between developed and developing countries are good for the latter, especially because they stimulate growth. The poor partners tend to benefit from the knowledge spillovers and policy credibility of the rich: increased interregional trade improves access to technology and RTAs usually induce institutional reforms (sound macroeconomic policies, well-defined property rights, an efficient banking sector, and so on) and make them more credible in investors’ eyes. An additional channel is that the poorer partners will benefit from attracting more industry as firms from member and nonmember countries migrate to them. Venables concludes that “although, as a general rule, the conclusions depend on the exact partners and the depth of integration, regionalism can be a valuable part of a development strategy as agreements that remove not only tariffs but other barriers to economic interaction.”

Estevadeordal and Robertson (2004) go even further and question whether, in a world with myriad bilateral trade agreements, additional FTAs do increase trade (via diversion or otherwise). They find that a tariff reduction among potential members of a Free Trade Area of the Americas would increase trade substantially. They also find that “the tariff-reducing effect of trade is larger in the Americas than in our full sample.”

Empirical Evidence: Cross-Country Growth Regressions

Two methodologies are often used by economists to test the hypothesis that openness has a positive impact on economic growth: cross-country regressions and case studies.

The cross-country regression methodology follows the work of Barro (1991) and essentially consists of estimating the partial correlation between

the openness of an economy and its aggregate growth rate over a period of time.⁶

A central question is how to measure openness. One line of research measures it by actual volume (usually, the sum of imports plus exports as a fraction of GDP). Levine and Renelt (1992) find that openness is one of the robust determinants of economic growth. But their empirical work has been criticized for failing to account for the endogeneity of trade flows and for the fact that exports are part of GDP. The endogeneity of the trade measures produces a simultaneity bias in the estimated impact, while exports being part of GDP produces an inherently positive correlation between them. Frankel and Romer (1999) propose a methodology for overcoming these shortcomings. They estimate a gravity equation of bilateral trade flows, in which various geographic characteristics and bilateral distances affect trade. They then use the trade flows predicted by the geographic characteristics and the distances between countries as instruments for trade to estimate the effect of imports plus exports as a fraction of GDP on income per capita. Frankel and Romer find a strong effect of openness on income per capita: a 1 percent higher trade share raises income per capita by 2 percent.

Using Frankel and Romer's instrumental variables methodology, Alesina and others (2005) also find that openness has a positive effect on growth. Moreover, they find that the same degree of openness has a larger effect in smaller economies. That is, being open is less important if your domestic market is already large.

Irwin and Treviö (2000) and Rodrik (2000) challenge the robustness of all these studies: they claim that when more variables are included, the effects of openness on income become insignificant in some samples.

The main problem with this line of research is that it is difficult to separate the effects of institutions from openness. Dollar and Kraay (2001b) overcome these measurement problems by looking at how differences in openness over time determine changes in growth rates, thereby eliminating institutional and geographic effects on growth (which are assumed to be more or less constant over time). The results suggest that a 20 percent increase in trade share increases

⁶ The variables that need to be added to each regression are subject to controversy. Most researchers follow the specifications of Barro and Sala-i-Martin (1992) and Mankiw and others (1992). Recent research on the robustness of estimates follows Sala-i-Martin (1997) and Sala-i-Martin and others (2004) and checks the robustness of additional regressors using Bayesian methods.

growth by between 0.5 and 1 percent a year. Dollar and Kraay (2001a, 2004) break the world into three samples: those countries whose trade as a share of GDP rose the most (they call this the sample of “globalizers”), those whose trade shares rose the least (the “nonglobalizers”), and those in the middle. They drop the countries in the middle and compare the average performance of the two groups in the 1990s relative to the 1980s: the growth rate of the globalizers was 5.3 percent while the growth rate of the nonglobalizers was only 0.8 percent.

Trade volumes depend on technologies, endowments, preferences, and a whole array of other factors. As a result, some countries would have low trade volumes even if their governments allow for free trade. Hence, studies that capture openness by trade volumes do not provide satisfactory evidence of the effects of trade policies on growth. Thus, a second line of research prefers to analyze the relation between growth and openness policies rather than openness outcomes.

Sachs and Warner (1995) construct a binary index that assigns the value of 1 when an economy is deemed open and 0 when it is deemed closed. Economies are labeled as closed if (i) tariffs lie above 40 percent, (ii) non-tariff barriers (NTBs) cover more than 40 percent of their imports, (iii) they have a socialist economic system, (iv) their exports are controlled by a state monopoly, or (v) their black-market premium exceeds 20 percent. They show that this qualitative measure of open policy is positively correlated with growth. Sala-i-Martin (1997) and Sala-i-Martin and others (2004) show that the Sachs-Warner index is one of the variables used in the literature that are robustly correlated with growth.⁷

These findings have been subject to criticism, most influentially by Rodriguez and Rodrik (1999), who show that the Sachs-Warner index is dominated by the criteria applied to state economy, socialist regime, and the black-market premium (iii, iv, and v). Hence, this index does not properly isolate the effects of openness on growth. Wacziarg (2001) confirms this hypothesis and studies the effects of the various components in the Sachs-Warner index. He finds that a one standard deviation increase in the restrictiveness of trade policies reduces the growth rate by 0.26 percent annually, which is an important and significant impact.

⁷ Hall and Jones (1999) show that the Sachs-Warner index is correlated with the level (not the growth rate) of productivity of nations. But they also show that institutions are very correlated with openness and so it is not possible to disentangle which one of the two affects the output per worker more.

Finally, some studies analyze the effect of openness not on the per capita growth rate of the economy but on employment or the wages of the poor. Along these lines, Krueger (1981) showed that “employment tends to grow faster in outward oriented economies” and that “the removal of both de facto market distortions and trade distortions benefits, in the long run, the employment creation process in most developing countries.” Krueger (1983) finds that trade openness has positive effects on wages and employment in developing countries. The natural presumption of this line of work would be that open policies should help reduce poverty in poor countries with comparative advantage in labor-intensive goods. This is because the poor are unskilled workers and are endowed with labor but no capital.

Using the Dollar and Kraay (2001b) sample of countries, Sala-i-Martin (2002) shows that the \$1/day poverty rates for the group of “globalizers”⁸ fell from 19.3 percent in 1980 to 3.6 percent in 1999, while the poverty rates for the “nonglobalizers”⁹ rose from 10 percent to 17.8 percent. In terms of poverty headcounts, while the total number of poor people *declined* by 500 million in the countries that globalized, the total number of poor citizens *rose* by 80 million in the countries that remained closed.

In sum, most of the evidence on the relation between openness and growth points in the direction that more open economies tend to enjoy faster growth rates for standard of living and faster rates of poverty eradication. An unbiased reading of the evidence suggests that, although the robustness of some of this evidence has been challenged, the overall balance is that openness leads to growth. More importantly, nobody has presented evidence that protectionism is good for growth. As Helpman (2004) puts it: “My view is that despite the many difficulties that exist in the literature, it is fair to conclude that the evidence favors a negative effect of *protection* on rates of growth in the post-World War II period. Importantly, there is no real evidence of a positive link for this era.”

Empirical Evidence: Case Studies

The second empirical methodology used by economists to uncover the effects of openness on welfare is case studies. Case studies allow researchers to

⁸ Recall that the “globalizers” are the third of countries that opened the most over the last two decades according to Dollar and Kraay (2001b).

⁹ That is, the countries that opened up the least since 1980.

identify more specific policies and institutional reforms for every country, but have the disadvantage that they cannot control for factors that are common across countries. We now discuss some case studies that support the view that openness tends to favor improved economic outcomes.

Asia. China is perhaps the best example of the positive connection between openness and economic growth. China undertook a unilateral trade liberalization during the reform period, prior to its accession to the WTO in December 2001. During this period, the average statutory tariff, which stood at the relatively high level of 56 percent in 1982, was reduced to 15 percent by 2001. China's share of global trade stands now at 4.3 percent, more than three times its share in 1982. China's fastest-growing exports have been labor-intensive manufactures—textiles, apparel, footwear, and toys (Lardy, 2003). This sizeable increase in the degree of openness has introduced substantial new competition into its domestic market and made Chinese firms more efficient and competitive. The average growth rate during the postreform period (1978–2005) has been close to 10 percent, compared with 3 percent for the period 1950–77.

The reforms have brought benefits to all provinces in China. But the coastal provinces have experienced larger economic growth than the inner regions. The reason is that inner provinces have been less open to trade (Chen and Feng, 2000). This uneven performance has led to the well-documented increase in income inequalities within China (Dollar and Kraay, 2001b). But this has not prevented a substantial decline in poverty: Sala-i-Martin (2006) estimates that Chinese \$1/day poverty rates stood at 31 percent in 1975 and they stand now at less than 3 percent (a decline by a factor of 10!). The total number of poor has been cut by more than 250 million citizens—a reduction like no other in the history of the world.

The success of China in eradicating poverty through growth and trade is the most spectacular in the world but it is not, by any means, an exception. Other Asian economies have shared this economic success: from the early dragons (Taiwan, Singapore, Hong Kong, and South Korea) to the East Asian tigers (Malaysia, Thailand, and India) to the latest success story of Vietnam, Asian economies have experienced substantial increases in average growth rates and substantial reductions in poverty rates and headcounts. Sala-i-Martin (2006) estimates that poverty rates in East Asia declined from 32.7 percent in 1970 to 2.4 percent in 2000 (which amounts to 300 million less poor people),

while the poverty rates in South Asia went from 30.3 percent in 1970 to 2.5 percent in 2000 (an additional 200 million citizens exited the state of poverty).

In most of these countries, outward-oriented industrialization was the central policy (although not the only one); heavy investments in education and institutional reforms were also prominent policies that explain the Asian success.

Mexico. An example of economic integration useful to Colombia is the case of Mexico. Mexico undertook a process of liberalization during the 1980s, a process that culminated in the signing of the North American Free Trade Agreement (NAFTA) with the United States and Canada in August 1992. NAFTA was implemented in 1994, which unluckily coincided with the devaluation of the peso and the subsequent financial crises of 1994 that led to a decline of Mexico's GDP by 6 percent in 1995. After this unfortunate start, things improved substantially: between 1995 and 2000, the annual growth rate of the Mexican economy averaged 5.4 percent. The growth rate decelerated to 0.6 percent between 2001 and 2003, but picked up to 3.9 percent from 2004 to 2006. Exports as a fraction of GDP grew from 19 percent before NAFTA to 30.4 percent today. Investment averaged 18.3 percent of GDP between 1989 and 1994 and 20.1 percent in the post-NAFTA period. Nicita (2004) estimates that NAFTA may have lifted up to three million Mexicans out of poverty.

The main impact of NAFTA on the Mexican economy is probably on employment: more than 6 million jobs were created in Mexico between 1994 and 2005. The unemployment rate remains very low at about 3 percent, which means that Mexico has been able to absorb a substantial increase in labor supply during the post-NAFTA period. More importantly, the relative importance of agriculture has declined while the weight of industry and services has experienced a substantial increase.

Interestingly, the process of commercial liberalization did not bring specialization in labor-intensive products (as predicted by traditional trade theory). Instead, the readjustment in production structure increased demand for skilled labor. The explanation is the role of FDI, which has brought new capital as well as better technologies that are complemented with skilled labor. Venables (2001) shows that "FDI flows into Mexico more than doubled in the years following the launch of NAFTA." This increase was explained by investment from firms of non-NAFTA countries taking advantage of

preferential access to the larger U.S. market. For example, Japan redirected part of its FDI from the United States and Canada toward Mexico, and many projects (such as the one in the automobile industry) are intended for the NAFTA continental market. Although this increase in FDI to Mexico did not seem to lead to spillovers in domestic nontradable sector productivity, it did generate larger productivity gains in the sectors that opened the most (López-Cordova and Mesquita Moreira, 2004).

The deceleration of the first three years of the new millennium may reflect the loss of competitiveness that results from increasing wages: the unemployment rate in Mexico is so low that an increase in demand results in wage increases and increasing costs.¹⁰ In this sense, the competition of China and other low-wage Asian economies has had a worldwide impact, including in Mexico (see Feenstra and Kee, 2007). Of course the slowing down of the period 2000–2 may also reflect a temporary downturn. The higher growth rates experienced by Mexico during the period 2003–6 support this more optimistic view.

The regional impact of NAFTA has been uneven. Most of the gains in employment and income have occurred in the northern regions close to the U.S. border (see Esquivel and others, 2002); the poorer regions of the south did not necessarily benefit. The reason, however, is that these regions are not economically integrated to take full advantage of the opportunities NAFTA brings: infrastructure and communications are poor, education levels and skills are low, and institutional and public sector problems abound. To benefit from economic integration with the United States, these regions should open up to the rest of Mexico.

Overall, López-Cordova and Moreira (2004) evaluate the overall impact of NAFTA on productivity and growth positively: “On the strategy of regional integration, Mexico’s more aggressive stance with NAFTA seems to have paid off, at least as far as productivity is concerned. Tariff reductions undertaken during the agreement appear to have a sizable positive impact on productivity growth, which added to the already substantial gains reaped during the period of nonpreferential liberalization.”

¹⁰ It is important to remember this point when one thinks of the likely impact of an RTA for Colombia since the unemployment rate in Colombia is substantially higher. Hence, the effects of an agreement for Colombia are likely to have much larger effects on employment than in Mexico.

Summary of Empirical Evidence

The best and shortest summary of the vast empirical literature on the relation between openness, growth, and poverty is given by Berg and Krueger (2003): “When we add the cross-sectional analyses to the substantial quantity of case studies, industry and firm-level research documentation, the evidence is convincing: openness contributes to productivity and ultimately income growth.”

6.2 Colombia and Its Potential Trade Agreement with the United States

Colombia and the United States are currently considering an FTA. Although originally the agreement included two other Andean countries (Peru and Ecuador), which is why the treaty is known as U.S.-Andean FTA, Peru and Colombia are negotiating with the United States separately. The negotiation between Ecuador and the United States has been postponed.

Many studies have been conducted to estimate the likely effects of this FTA on the levels of income, employment, salaries, and poverty in Colombia. These estimates are done using computer simulations of general equilibrium models. Of course, the impact of economic integration depends on a variety of elements, including the degree to which U.S. NTBs are reduced, especially in the agricultural sector (see Martín and Ramírez, 2004). This section discusses some of the results of this research. The main summary is that the likely effect of an FTA will be a substantial positive impact on the Colombian economy.

Giordano and Watanuki (2007) develop and calibrate a computable general equilibrium model to examine the sectoral, regional, and distributive effects of the agreement (through microsimulations based on household survey data). The authors conclude that the FTA will be responsible for a moderate decrease in overall poverty and indigence.

Volpe Martincus and others (2006) show that tariff reduction under the Andean Trade Promotion and Drug Eradication Act (ATPDEA) favored export diversification of Colombian products into the U.S. market. Moreover, based on empirical evidence from Mexico, Chile, and Colombia, they conclude that an FTA with the United States will promote an expansion of the Andean country's export portfolio. However, significant reforms in key

areas such as infrastructure, education, and institutional development are in urgent need to take full advantage of new market access.

FEDESARROLLO (2004) estimates that an FTA would increase bilateral trade by an additional 40.5 percent. Using the point estimates of Frankel and Romer (1999) and Dollar and Kraay (2001a) as discussed earlier, an increase in trade of this magnitude would be associated with an increase in per capita income of between 8 percent and 33 percent. FEDESARROLLO also estimates that if no bilateral agreements are put in place when the current ATPDEA expires, overall trade between Colombia and the United States would fall by 56.6 percent. This would imply a fall in Colombian per capita income of 12 percent to 47 percent! Not signing an FTA once the ATPDEA expires, therefore, could have potentially devastating effects on the incomes of Colombian citizens.

It is very hard to say whether the increase in trade would come from diversion or from creation. But because the United States is Colombia's main trading partner and because the United States is already a rich and efficient economy it is very likely that the FTA between Colombia and the United States not only does not divert trade but actually "undoes" some of the diversion that previous regional agreements among southern partners (such as the Acuerdo de la Comunidad Andina, the G3 agreement with Mexico, and the partial bilateral trade agreement with Chile) may have caused.

Other than the impact on trade, the FTA would also have an impact on the Colombian labor market. Botero (2004) estimates that a total of 270,000 jobs would be created, that the demand for skilled labor would increase by 1.4 percent, and that the demand for unskilled labor would grow by 5.5 percent. Skilled wages would grow by 4.5 percent while the effect on unskilled wages would range from 0 to 1.58 percent, depending on the study. The explanation behind the small change in unskilled wages is that unemployment rates are high. Hence, increases in the demand for unskilled labor would be met by job creation rather than by increases in the salaries of the employed.¹¹

Since the poor in Colombia tend to be unemployed, the creation of jobs alone will have a substantial impact on the reduction of poverty. This conclusion is consistent with the findings of Bussolo and Lay (2003), who combine a computational general equilibrium macro model with a microeconomic

¹¹ This is different from what happened in Mexico as a result of NAFTA because unemployment rates in Mexico were substantially lower.

model of income distribution to study the role of openness in poverty in Colombia. This combination of micro- and macrodata allows them to identify the income distribution effects of macropolicies and the movements in and out of poverty for a variety of groups in both urban and rural areas. The paper shows that the tariff reduction experienced by Colombia at the beginning of the 1990s induced a substantial reduction in poverty rates.

Aggregate GDP is predicted to increase by more than 5 percent. Moreover, the growth is likely to occur in the industrial (expected growth of 6.8 percent) and services (5.3 percent) sectors. Both imports and exports are expected to increase by 10 percent. And most importantly, investment is predicted to increase by more than 30 percent.

We have argued repeatedly throughout this chapter that the main benefits of openness are likely to be dynamic. That is, they are likely to come from both the transmission of knowledge due to transnational capital flows and the improvement of the institutional environment. These most important elements are not captured by the computable models used to estimate the likely impact on the Colombian economy. Lawrence Summers believes that the institutional channel will probably be the most important one through which openness affects the well-being of citizens. This is true in general, but especially for Colombia. As the U.S. ambassador to Colombia said in a speech (Portman, 2006): “An agreement with Colombia will be useful to combat narco-trafficking, build democratic institutions, and promote economic development. In addition to eliminating tariffs, Colombia will remove barriers to trade in services, provide a secure, predictable legal framework for U.S. investors operating in Colombia, provide for effective enforcement of labor and environmental laws, protect intellectual property, and provide an effective system to settle disputes.”

Additional Comments and Warnings

Let us conclude with four policy warnings. First, although economic integration will bring greater well-being for the average citizen, it will not bring greater good to all Colombians. This, of course, is true for virtually *all* policy decisions, institutional reforms, or even technological innovations: every change will have its winners and losers. After every modification, there will be citizens, companies, sectors, or regions that will lose. Having said that, this is an inadequate reason to not undertake these reforms, to stop

the process of progressive opening up, or to prevent technological progress from taking place. After all, the gains of the winners will be larger than the losses of the losers, and in the longer run everyone may end up benefiting. Authorities should always keep this in mind and thus should put in place the necessary safety nets to protect those that will lose from the process. The safety nets should be designed intelligently to assist the losers in adapting to the new environment and should not create an underclass of people who permanently depend on public welfare. But the protection policies should focus on protecting individuals rather than their jobs. That is, the safety-net policies should help workers who will likely lose their jobs retrain and find other employment opportunities. In this sense, most of the literature states that investment in education (versus other publicly sponsored policies) is the most effective weapon.

Second, an important part of the gains arising from greater integration with the United States (especially for poor Colombian citizens) will come from foreign investment. Colombian authorities should be ready to welcome and nurture foreign investment and should stand ready to reform Colombia's institutions for the greater good of its citizens.

Third, economic integration will be more general from a regional point of view if all the regions in Colombia are themselves integrated. The case of Mexico shows that regions that remain isolated do not reap the benefits of openness. In this sense, efforts should be made to keep all regions connected and prepared to compete. The slower growth of the inner regions of China is also an example of regional inequalities that are created when regions are not appropriately connected to the rest of the world. The Chinese government is now trying to connect the inner regions both physically (infrastructure, water supplies, electricity, air transportation, railways, and highways) and in terms of communications (Internet, telephone, and broadband access) and the rest of the elements that guarantee the foundations of sound economic growth. Governments should not be tempted to introduce large-scale welfare programs in these poorer regions. Such an approach might be dangerous because it would increase incentives of poor citizens in other parts of the country to migrate to these regions, converting the disadvantaged regions into large pockets of poverty. A better alternative in the case of Colombia is to make every effort to integrate both the poorest and the most isolated regions of the country with the rest of the economy so that their citizens can also reap benefits from Colombia's international integration.

Which leads us to the last point: openness and economic integration with countries that are the economic, technological, and financial leaders of the world is an important determinant of future economic prospects for Colombia and Latin America. But openness is not the magic bullet that will solve all the economy's problems. The overall competitiveness of Colombia depends on a constellation of other factors. Sala-i-Martin and Artadi (2004) designed an index for the World Economic Forum (WEF) that measures the key determinants of competitiveness of nations. To capture the complexity of the process of economic development, the index is based on 12 pillars. This means that countries need to work on each and every one of these aspects if they want to take full advantage of better market access conditions achieved through negotiations and thereby see balanced and sustained growth. The pillars are:

- *The institutional environment.* Protection of property rights; reduction of excessive bureaucracy and red tape, corruption, public dishonesty, and lack of transparency; increased trustworthiness; and decreased political dependence of the judiciary and law enforcement sectors.
- *Physical infrastructure.* Railways, ports, airports, roads, telephone, electricity, and access to new technologies should be improved.
- *Macroeconomic stability.* Countries with excessive public deficits, inflation, or unstable exchange rates cannot be competitive.
- *Security.* A country that cannot guarantee the safety of managers, administrators, employees, or even customers because of military conflicts, terrorism, organized crime, or political and economic kidnappings is a country that cannot be competitive.
- *Human capital.* Education at all levels (from efficient primary schools to productive universities) is important. Health is also a key determinant of the productivity of the labor force.
- *Efficiency of the goods sector.* Competition is the greatest source of competitiveness and, therefore, the government must protect it and stand up against monopolies. The government should avoid participating in the game with public enterprises whenever that is possible. It should be the referee of the game, not the main player.
- *Efficiency of the labor market.* Inefficiencies in the labor market tend to generate unemployment. Inefficiencies take a variety of forms. Some of them are legal, while others are mental. Citizens should be encouraged to move across regions, sectors, firms, and jobs. Mobility is necessary

in a world that changes constantly. Salaries should reflect merit rather than political or family relations. Governments should also encourage the efficient use of female talent: a country that wastes half of its talent cannot be competitive.

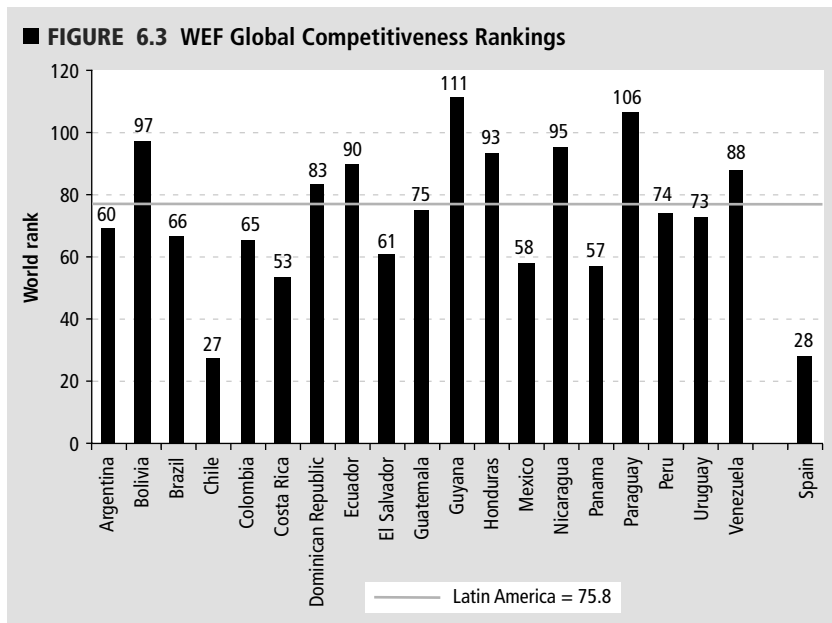
- *Financial efficiency.* The financial sector should ensure that financial resources end up in the most productive uses. To make sure that entrepreneurs get the necessary financial resources, companies of capital risk should be encouraged.
- *Technological readiness.* A competitive country must have access to state-of-the-art technologies. This does not mean that it has to invent these technologies, but it must be ready to implement them as soon as they are invented elsewhere.
- *Openness.* As discussed throughout this chapter, open economies tend to be more competitive than closed ones.
- *Business sophistication.* As countries develop, they should encourage the production of goods with high value added. They should promote the creation of clusters that guarantee easy access to inputs and complementary outputs and that encourage connections among producers. A good model to follow and to learn from is that of the Basque Country in Spain.
- *Innovation.* The final stage in the long process of economic growth is innovation. When you cannot compete by doing things more cheaply than others, you must do different and new things. That is, you need to innovate. Although innovation is crucial for rich and developed countries, it is also important at all levels of development. Innovation can and must occur in agriculture, textiles, food processing, light industrial sectors, heavy industry, services, the financial sector, and so on. Ideas can be generated everywhere and, most important, ideas can be implemented everywhere. The government should create an environment in which private citizens find it easy to implement their ideas in whatever sector they happen to work. Sala-i-Martin and Artadi (2004) point out that the different pillars have different degrees of importance at different levels of economic development but that they all matter for all countries.

Sala-i-Martin and Blanque (2007) use the WEF Executive Surveys to estimate the level of competitiveness for 125 countries. Because these surveys are completed by businesspeople, the results can be interpreted as showing how the business community sees the economic prospects of the nations in

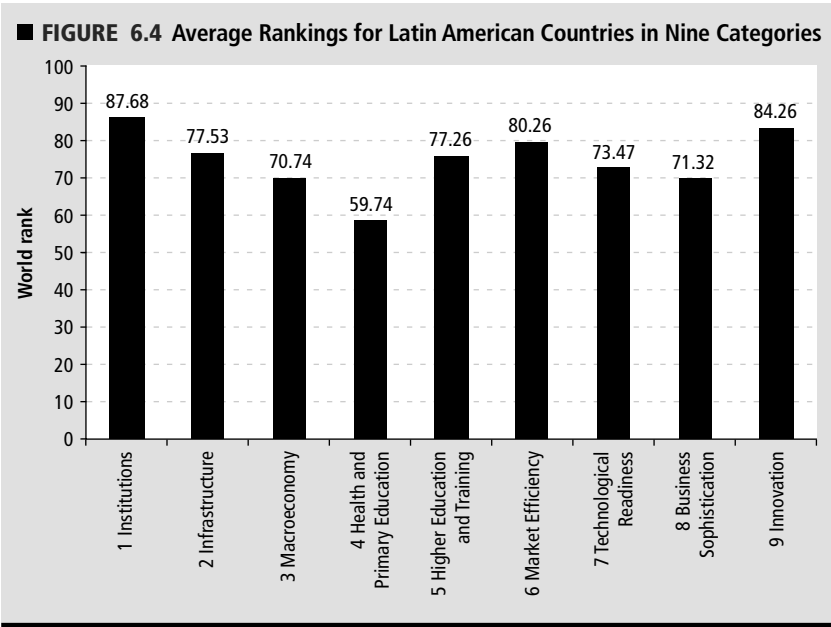
which it operates. Of course, the business community's view is not the only one that matters, but if we were to choose one community whose view matters the most, it would be the one. After all, business leaders are the ones who will make investment, employment, production, and location decisions in the near future.

The results for Latin America are not very encouraging. Figure 6.3 reports all the available rankings for Latin American countries. We also depict for comparison the indicator for Spain, which is one of the worst performers in the Organisation for Economic Co-operation and Development and the EU. The best-positioned country in the region is Chile at 27th, one rank above Spain. Costa Rica, Mexico, and Panama are ranked in the 50s, and Argentina, Brazil, Colombia, and El Salvador in the 60s. The worst-ranked countries in the region are Guyana, Paraguay, Bolivia, Nicaragua, Honduras, and Ecuador.

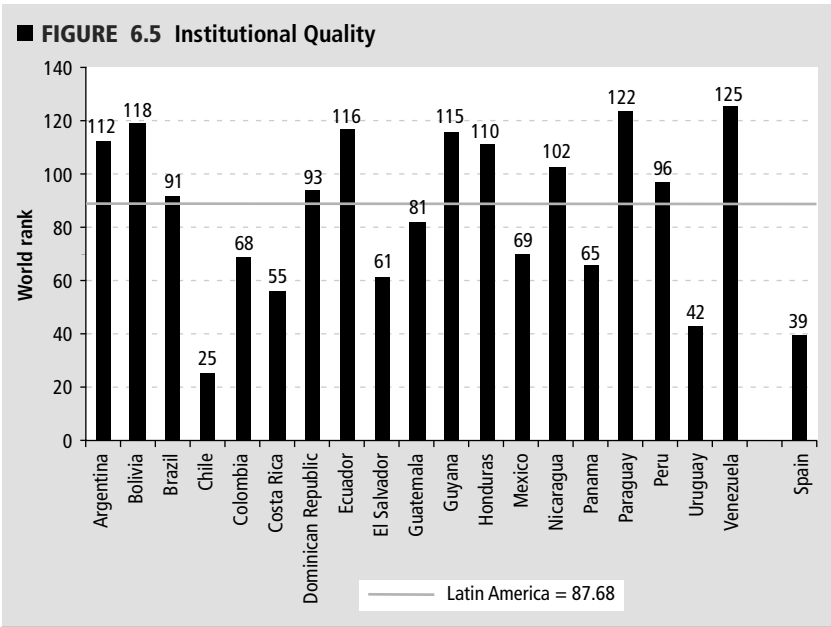
If we average Latin America for each of the pillars, we see that it does not perform too well in regard to any of them (figure 6.4). The best average rank is that for health and basic education (average position 59.7) while the worst are those for the institutional environment (87.7) and innovation (84.26). Figure 6.5 shows how each country scores on the institutional environment pillar.



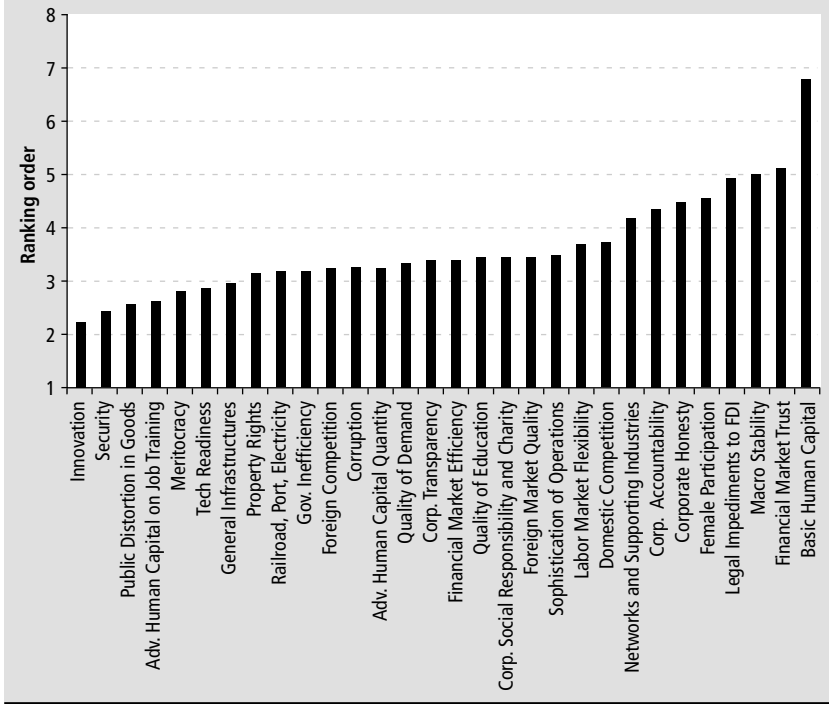
Source: Author's calculations based on World Economic Forum.



Source: Author's calculations based on World Economic Forum.



Source: Author's calculations based on World Economic Forum.

■ **FIGURE 6.6** Elements of Competitiveness for Colombia

Source: Author's calculations based on World Economic Forum.

When it comes to institutions, the worst performer in the world is Venezuela, while Panama ranks 122nd out of 125 countries. Bolivia ranks 118th, Ecuador 116th, Guyana 115th, Argentina 112th, and Honduras 110th. The only countries with reasonably ranked institutions are Chile (25th) and Uruguay (42nd).

Finally, figure 6.6 reports Colombia's scores on 30 elements of competitiveness (as seen by the Colombian business community). These elements are ranked from the worst score to the best. Colombia scores fairly well in basic human capital. It scores fairly well in trust in the financial sector, macroeconomic stability, and legal impediments to FDI. At the opposite end, Colombia's worst problems can be found in the areas of innovation, personal security, and publicly induced distortions in goods and labor markets.

In sum, although trade liberalization and integration are likely to benefit the region, Latin American countries have a lot of homework to do in many other dimensions.

6.3 Conclusions

This chapter summarizes the theoretical arguments and empirical evidence on the relationships of openness, poverty, and economic development. When cross-country empirical evidence and case studies are put together, the evidence is convincing that economic integration improves standards of living, increases economic growth, and contributes to the reduction of poverty. This is true in general and in the case of RTAs. The main channels through which openness is likely to reduce poverty are dynamic channels that are not captured by traditional trade theory. Among these dynamic factors, perhaps the most important is the transmission and coordination of policies and institutions that lead to greater economic efficiency, increased productivity, and higher growth rates. These factors are likely to be important in the case of Colombia, if the FTA is finally ratified.

Although the FTA will clearly be good for Colombia, the Colombian government should make sure that additional policies are put in place to guarantee that the potential losers have a safety net, that the disconnected regions of Colombia get connected (so that they can also reap the benefits of more integration), and that the other factors that help promote economic growth and competitiveness are progressively introduced.

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INTEGRATION AND TRADE

Understanding the complex relations between trade integration and poverty reduction is now a priority for Latin American policymakers. The chapters of this book, penned by eminent authors with a long-standing record in the field, represent the current state of knowledge about trade and poverty and offer contrasting points of view about whether freer trade can reduce poverty in Latin America. One of the main lessons extracted from the book is that preexisting policies and socioeconomic conditions play a key role in determining how trade integration affects poverty. Because transmission channels are complex and highly contextualized, policymakers are urged to adopt complementary policies tailored to their countries' circumstances in order to ensure an equitable distribution of the gains from trade.