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# Toward a New Social Contract in Latin America

**By Nancy Birdsall and Rachel Menezes***

**Summary:** The "lost decade" of the 1980s in Latin America was followed by low growth and financial crises in the 1990s. More than a decade of renewed democracy and open market economic reforms have failed to deliver much growth or social progress, causing a spiral of anxiety and deep frustration in the region— with the political process, with political leadership, and with the way democracy is working. Economic activity in the last five years grew by only 2 percent on average, barely keeping up with population growth, compared to 3.7 percent worldwide, and to 3 percent in the 1990s. The proportion of the poor, which had been declining, has increased since 2000, not only in Argentina, where poverty rates have doubled, but also in Bolivia, Peru, Uruguay, and Venezuela. Income inequality remains high. Public opinion polls show Latin Americans tired of fiscal austerity, record high unemployment, and stagnant wages, and resentful of privatization and other so-called Washington Consensus reforms. Around 55 percent of people surveyed say they would not mind a non-democratic government if it could solve economic problems. Ten years after the first Summit of the Americas, the hopes for broad-based prosperity and poverty-reducing growth based on a strengthened marriage of open market and renewed democratic politics seem far from realized.

Although increased public social spending in the 1990s did benefit the poor to a degree, the economic reforms benefited mostly the already rich and well educated, without generating either growth or jobs. The squeeze for working class and middle-income households in urban areas has led to a heightened sense of insecurity and a growing opposition to market reforms.

This policy brief proposes a new job-based **social contract**, geared to the aspirations of the region's vast majority of near-poor "middle" households, whose participation is key to achieving growth and strengthening democracy. This contract would emphasize tough and transparent fiscal management; make taxes and expenditures more progressive to "grow" a new middle-class; protect job mobility and workers' rights (rather than jobs); and emphasize access to global markets, including through regional collaboration.

## Middle and Low-income Households Are Falling Behind

Economic insecurity is hard to avoid in today's open economies. But three grim realities in Latin America create the need for a politically visible and more explicitly "fair" job-based, open-economy social contract:

**1. Job growth has been extremely weak, increasing insecurity among middle-income households.** Jobs were not on the reform agenda of the 1990s, and in retrospect, they were surprisingly absent even in the political discourse. But they are now the number one concern in Latin America—ahead of poverty, corruption, crime, and other social problems. The following trends in the labor market are causes for concern:

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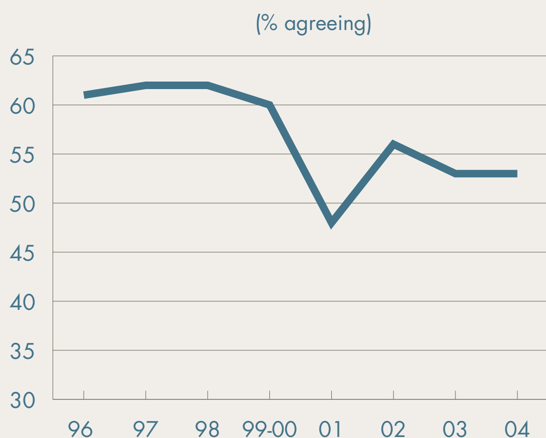
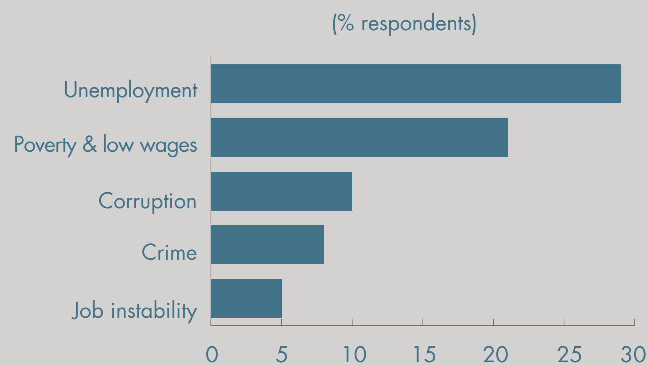
**Figure 1:** Economic and social problems test Latin Americans' faith in democracy



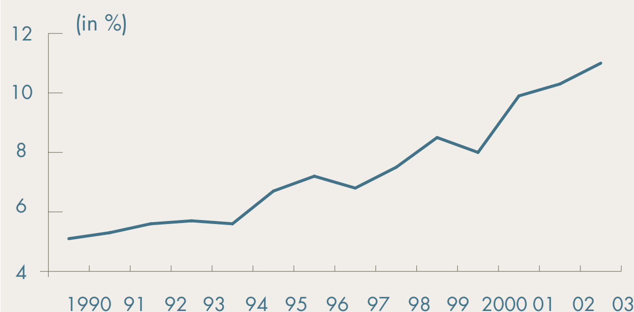




**Source:** Latinobarometro 2003 and 2004.

*Rise in open unemployment and lack of social protection.* Unemployment has risen from around 5 percent in 1990 to 11 percent in 2003, the highest level ever recorded in the region (Figure 3). The share of workers covered by labor regulations and social protection today (around 40 percent) is less than it was in the early 1990s, making unemployment particularly painful in the region. In Mexico and Argentina, more than 60 and 80 percent respectively of the unemployed that find jobs do not receive social security benefits.

*Weak job creation, concentrated mostly in low-productivity activities.* Between 1997 and 2002, employment expanded by less than 2 percent a year in the region. During the 1990s, job growth was only 2.2 percent, well below the 3.2 percent rate of economic growth. Most countries have seen relative increases in the share of jobs considered low quality, such as involuntary part-time work, temporary employment, self-employment, and jobs in very small firms.

**Figure 2:** Unemployment rise in Latin America, 1990 –2003




**Source:** International Monetary Fund, World Economic Outlook April 2004 (Washington, DC: 2004).

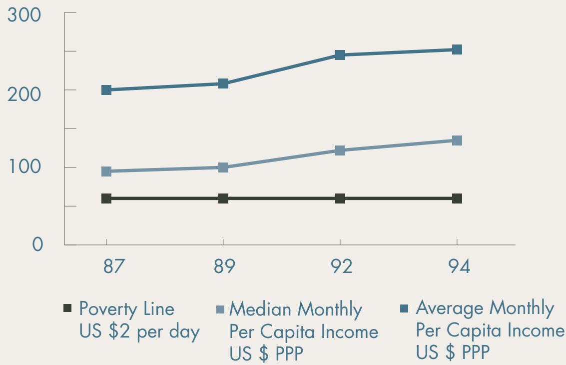
*Widening wage gap between workers with higher education relative to primary and secondary education.* Wages have increased much faster for those with more than secondary education than for the majority who have less education. In Brazil and Colombia during the 1990s, the wage premium for workers with primary and secondary education actually fell, while the premium for those with university and other post-secondary training rose substantially. Equally worrying is the decline in the average wage differential between workers with secondary vs. primary education, to the point where secondary education, with its high opportunity cost in lost wages, may no longer seem worthwhile to adolescents who see no prospects for going on to complete post-secondary schooling.

**2. Middle-income households in Latin America are not "middle class" at all, but actually rather poor.** Global markets have brought economic insecurity to middle-income households everywhere. But the anxiety is particularly acute for that group in Latin America because middle-income people are far too poor to be called "middle class." In the U.S., median national income is about 90 percent of average national income. By contrast:

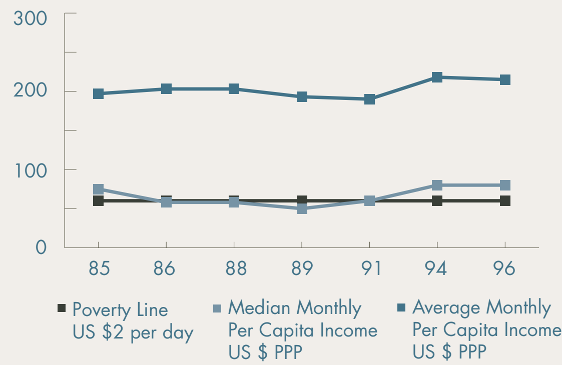
- In Honduras, median income per capita was lower than the World Bank poverty line of $2 per day between 1989 and 1996.
- In Brazil, median household income per capita was only about a third of average national income in the 1990s.
- In Chile, median income has been about half of average income.

**Figure 3:** Low levels of income and health of middle-income families in Latin America

**Chile**

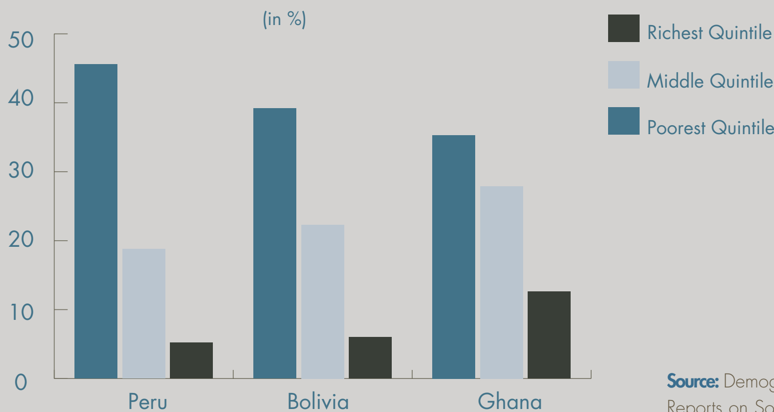



**Brazil**




**Source:** Birdsall (2002).

**Rate of stunting for children under 3 (Bolivia and Ghana); under 5 (Peru)**




**Source:** Demographic and Health Survey (DHS) data at World Bank Country Reports on Socio-economic Differences in Health, Nutrition, and Population (2002). DHS: Peru (1996); Bolivia (1998); and Ghana (1993).

The health and education levels of middle-income households are also well below anything we would expect for the middle class in the Western sense:

- In Peru during the 1990s, almost 20 percent of children under the age of five in middle-income households were stunted. In Bolivia, children under three in the poorest quintile of households were more likely to be stunted than the children in Ghana's poorest quintile.

- In Bolivia, the median level of education among adults is still below two years. In Argentina, it is just above five years.

Because so many middle-income households are close to the poverty line, even short-term economic downturns can drive them into poverty. In Argentina and Venezuela, economic troubles in the last five years have created an entire class of the newly poor, with as much as 41 percent of all households in Argentina, and 69 percent in Venezuela, now counted as poor. In Brazil between 1981 and 2002, there was a 6.5 percent drop in the number of wage earners reporting income above R$1,000 ($346), and a 5.4 percent increase in the number reporting income below R$500 ($173).

**3. Middle-income and poor households benefited from reduced inflation, but were squeezed by the structural reforms of the 1990s.** Reduction of expenditures, the write-off of debt (including with privatization proceeds) and steadier monetary and exchange rate policy reduced inflation in the 1990s, and reduced volatility in countries that escaped the financial crisis of the late 1990s. Analyses of the effects of structural reforms—trade and financial liberalization, opening of capital markets, privatization, and deregulation—suggest that Latin America would overall be worse off without them. Per capita income and output would have been lower, volatility higher, and poverty deeper. On the other hand, the visible benefits of the structural reforms have been minimal in terms of growth, and largely concentrated among those with higher education and initially higher assets.

**Table 1.** Estimated effects of policy reforms on inequality and poverty from existing studies

**(+ means inequality (poverty gap in last column) increasing; - indicates inequality (poverty gap in last column) reducing; and 0 means no robust effect)**

| Study | Morley/ECLAC | López | Behrman, Birdsall, and Székely (Penn) | Behrman, Birdsall, and Székely (UNDP) |
|---|---|---|---|---|
| Variable | Gini index of inequality | Gini index of inequality | Wage differentials | Poverty |
| Trade liberalization | + | + | o | o |
| Financial liberalization | o | + | + | + |
| Capital account liberalization | - | .. | + | .. |
| Tax reform | + | .. | + | .. |
| Privatization | o | .. | - | .. |
| All | o | .. | + | .. |

**Source:** World Bank, Inequality in Latin America: Breaking with History? (Washington, DC: 2004), Table 8.1; Jere Behrman, Nancy Birdsall and Miguel Székely, Pobreza, Desigualdad, y Liberalización Comercial y Financiera en América Latina (Buenos Aires: United Nations Development Program, 2001).

## The Elements of an Open-Economy Social Contract

In crafting a social contract, we bring together three elements related to domestic policy, and one to policies of the advanced economies. The social contract is based on the premise that Latin American economies will remain open in order to exploit the potential benefits of integration into the global economy. But it also recognizes that the integration process will produce losers as well as winners, and probably continue to help only a small minority of households in the region. Moreover, heavy reliance on external savings and the resulting vulnerability to financial and other crises could continue to create instability that hurts not only the poor but a much larger swath of non-rich households. The four elements that make up the social contract are:

**1. A radical fiscal policy aimed at creating a strong fiscal base and lower interest rates.** Radical fiscal management is the central ingredient of an open-economy social contract. It implies a willingness and political ability during good times to reduce public debt. The word "radical" is intentionally used to convey that the standard for Latin America, with its bad history of inflation and poor debt management, must be higher than that for the U.S. and Europe. With the sole exception of Chile, every country in the region has run an overall fiscal deficit since 1993, and thus cannot escape the burden of generating surpluses during years of growth for many years to come. Fiscal surpluses are critical to the social contract for two reasons:

*Reduced public borrowing would help lower interest rates, which in turn might raise private investment and job creation.* Real interest rates in Latin America averaged over 10 percent during the 1990s, compared to about 5.6 percent in the US, and 6.3 percent in Southeast Asia. Since 2001, interest rates have eased slightly against a backdrop of fairly low inflation (except in the Dominican Republic and, to a lesser extent, in Colombia). But they remain relatively high at almost 9 percent, compared to the world average of 2 percent. Reducing interest rates will be key to generating jobs for the vast majority of the workforce with limited education in Latin America.[1] Its positive impact on the ability of businesses to borrow would encourage the investments and growth that create new jobs.[2]

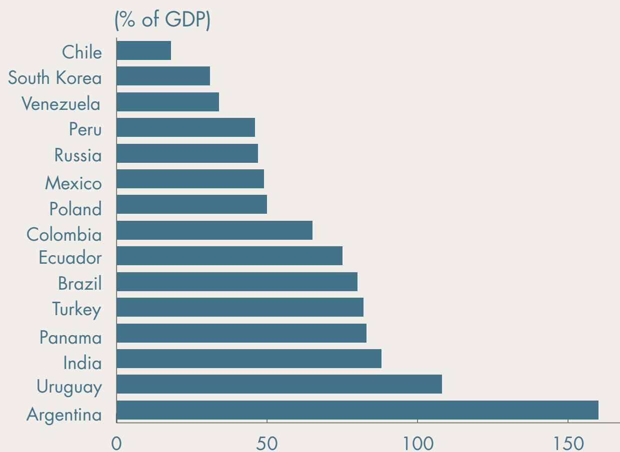
*Public savings (i.e., a fiscal surplus) permit countercyclical policy to protect the poor and the middle class during economic downturns.* During recessions in developed countries, governments increase spending to adopt measures that constitute a social safety net for their citizens. Increased spending can sometimes generate a fiscal deficit that can in turn help to stimulate a sluggish economy. In Latin America, however, governments cannot respond with that kind of countercyclical policy. Few countries, with the possible exception of Chile, have local financial sectors able to absorb more debt, except at high costs, and few command sufficient confidence in external markets to borrow in bad times. In some cases, adding to a fiscal deficit could further undermine confidence, thereby incurring even higher interest rates. Ironically, the best way to deepen domestic credit markets and improve access to external credit is to manage a string of fiscal surpluses that are demonstrably sustainable.

The ability to drive down real interest rates and to implement countercyclical policy is thus at the heart of an open-economy social contract. The message of Latin American political leaders should be clear: fiscal discipline is the foundation of a social contract that works for the poor, the working class, and middle-income households.

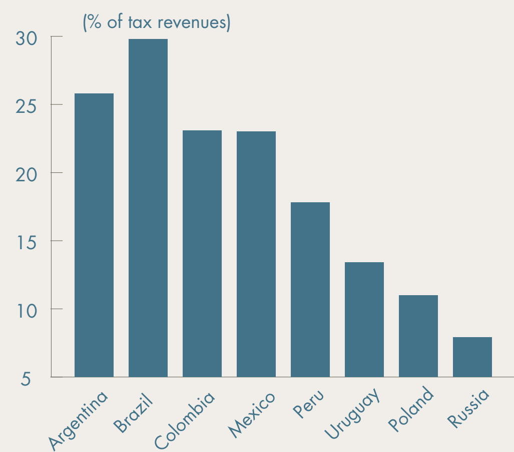
## Box 1: Public debt in Latin America

Latin American countries have public debt well in excess of 50 percent of GDP (with the exceptions of Chile, Mexico, Peru and Venezuela). In Argentina, public debt went from 30 percent of GDP in the early 1990s to over 150 percent at the end of 2002. This is well above the 25 to 30 percent debt-GDP ratio considered sustainable over time for emerging markets (in the region, only Chile and maybe Venezuela meet that standard). Even more important is the ability to service such high stock of public debt. Brazil spends a large percentage of tax revenues on interest on debt (30 percent in 2001). It also borrows regularly in the domestic market to meet its obligations—but at very high rates. The real interest on a 5-year Real-denominated treasury bond (NTN-C) is currently more than 8 percentage points above inflation.

**Total debt**




**Interest payments on public debt**




**Source:** World Bank FINCR and International Monetary Fund. Data for total debt are for 2002. Data for interest/taxes are for 2001.

### 2. A fair fiscal system that makes taxes and expenditures more progressive.

*Making tax systems more progressive.* In most Latin American countries, the richest 10 percent of households pay little in taxes. Loopholes and evasion are the norm. In Argentina, Chile, and Guatemala in the mid-1990s, the richest households faced a tax burden of no more than 8 percent of their income, even though the theoretical tax rates were far higher. Overall revenue collection can only be poor when households that control more than 50 percent of income contribute so little in taxes.

Latin America relies heavily on the value-added tax (VAT) which, along with other taxes on consumption, accounts for about 60 percent of total revenues in the region, compared with about 30 percent in Europe. As a tax on consumption, the VAT is not in itself progressive (though it can be, and is administered in a manner to limit its regressive impact). Moreover, like payroll taxes (because of the way they are generally administered) it is an invisible tax, with citizens unaware of its burden. It cannot embody for Latin Americans the flip side of the social contract between the state and citizens, whereby citizens take responsibility for financing the state and hold their political representatives accountable for responsive and responsible government.[3]

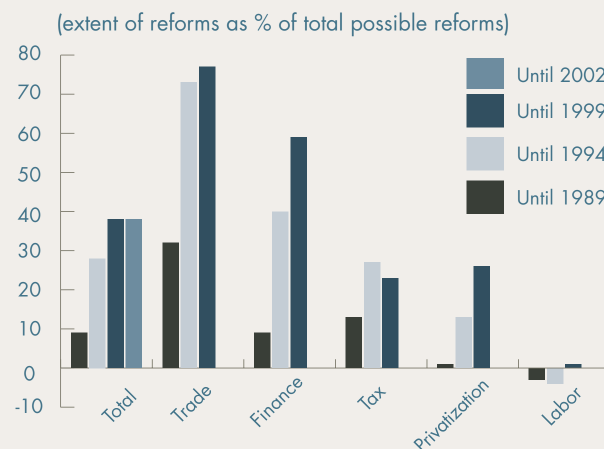
Implementing more visible and more progressive tax policies does not require raising marginal tax rates. It requires reducing evasion, eliminating loopholes, and improving tax administration. It might also imply an increase in the sales tax on luxuries or reinstatement of a modest tax on imports, done across the board for revenue rather than for protection; and implementing other progressive taxes such as a tax on property (implying investment in municipal tax administration), taxes on income from assets held abroad, and a tax on gross assets, which could be treated as minimum corporate tax (deductible from corporate income tax), as in Mexico. The resulting revenue would be stabilizing, rising in booms and falling in recessions.

Most economists endorse the view that tax systems should not bear the burden of income redistribution–that redistribution should instead be handled on the expenditure side. But in fact the U.S. and most societies in Europe do rely on taxes to build in some progressivity; and with greater tax revenues are able to spend more on health, education, and other means for contributing to the real income of the non-rich. In Latin America tax revenues in most countries average only about 18 percent, limiting such spending.[4] So a first step in the region would be to increase overall revenue collection.

*Reducing regressive expenditures such as pensions.* Most Latin American countries do manage a distribution of expenditures, especially on social investments, that is more progressive than the distribution of income. But in some countries, such major areas of expenditures as pensions for civil servants and the military are both inefficient and unfair. In Brazil, social security represents about 66 percent of total social spending. The deficit on the civil service system, which only covers 10 percent of pensioners, constitutes around 3.5 percent of GDP. In a country struggling to sustain a primary fiscal surplus target of 4.25 percent of GDP, that is a huge fiscal burden—and one that, short of reform, will grow as the population ages. Although the reforms pushed through last year are a step in the right direction, they save only about 0.2 percent of GDP.

**3. Job-creation and protection of workers' rights.** The low-income status of supposedly middle-income households in most Latin American countries is caused by the difficulty in generating massive formal employment. A social contract that is meaningful for middle-income households cannot ignore the insecurity and lack of protection against economic downturns faced by the vast majority of the region's workers. Labor market reform is the least advanced in Latin America compared to the other economic reforms, presumably because the emphasis on labor market "flexibility" has been so politically threatening to the remnants of the pre-1980s social contract based on industrial sector job protection.

**Figure 4:** Progress of reforms in Latin America




**Source:** Eduardo Lora, A Decade after the Great Wave of Structural Reforms: What Have We Learned? (Washington, DC: Inter-American Development Bank, 2004).

An open-economy, job-based social contract implies placing a heavy premium on creating as opposed to protecting jobs, and thus on the income and consumption of the great majority of households. It means taking into account that jobs are not only about income but also about dignity and a place in society. Two big policy shifts are required:

*Protecting job mobility, not job stability.* Unemployment insurance in Latin America can be built on a partially self-financed program of mandatory employee and employer contributions to individual accounts, which can be rolled over into retirement funds. Chile has developed such a funded and portable system of individual worker accounts that can be used for unemployment insurance, as well as a limited set of other worker initiated withdrawals, e.g., for purchasing a home. This approach could provide a real substitute for high minimum wage levels, excessive severance payments, rigid pension benefits, and other privileges that hinder formal employment due to their high impact on labor costs. In addition, health insurance, unemployment insurance, and pension systems could be designed for informal sector workers. Spain has had success in implementing programs in these areas for the self-employed.

**Box 2:** Lula's fiscal policy in Brazil

Since taking office in 2003, Brazilian President Luiz Inacio Lula da Silva has been increasingly criticized by members of his own cabinet and Worker's Party for continuing the disciplined macroeconomic approach of his predecessor, Fernando Henrique Cardoso, at the expense of much-needed investments in the social sectors. But Lula's critics are missing the point. Fiscal discipline is good social policy. Fiscal surpluses support lower real interest rates for job creation. Interest rates in Brazil peaked at 35 percent in 2002, before Lula's election. They have stabilized since, reaching their lowest level since 1995. But to lower interest rates to single digits, Lula will have to not only sustain fiscal discipline but push through politically difficult reforms in pensions and taxes.

*Protecting all workers' rights.* The collective bargaining rights of workers need to be protected, along with regulatory programs to ensure that unions themselves are genuinely democratic, allowing individual workers to be heard. Workers in the informal sector also need programs to provide minimal economic security.

**4. Access to rich country markets.** A job- and growth-based social contract for an open economy relies on openness, not only of the region's economies to each other but also that of external markets. At least some of the instability that has been so costly to middle-income households and the poor would be reduced for the region if it had access to the U.S. and European markets. For example, Brazil's recent higher export growth has helped reduce its external borrowing needs, in turn reducing its vulnerability to the risk of a sudden stop to external creditors' lending.[5]

Moreover, jobs created in sectors such as agriculture, shoes, and textiles would increase demand for less-skilled labor. The benefits of joining the global economy would then be increased for the vast majority of households where adults still have relatively little education. Although there is no good evidence that trade liberalization in the region has hurt the poor, there is little evidence that it has helped either—in part because advanced economies' markets are least open to agriculture and apparel.

The kind of social contract we envision would be advanced by a more liberalized global trading regime. This is the "social" argument for Latin American countries to unite behind in the context of negotiation of the Free Trade Area of the Americas (FTAA), and in the multilateral Doha trade round.

## Conclusion

Latin America has undertaken one set of changes in the direction of more open and competitive market economies. The growth benefits of that first important step need now to be complemented and reinforced by a second step—a social contract focused heavily on jobs and growth. This implies radical fiscal management, with tax and expenditure reforms; an emphasis in the labor market on encouraging worker mobility rather than protecting jobs; and pressure on the U.S. and the other advanced economies to open their markets. Along with traditional pro-poor policies, especially increasing educational opportunities, a broader social contract would help address the deep sense of injustice that the region's high inequality has caused, and rekindle hope that open markets and democratic institutions can reinforce each other.

## Notes

1 In the OECD, higher real interest rates have been shown to contribute to higher unemployment. Estimates of the relationship show no statistically robust effect in Latin America, but that could be because of unreliable data.

2 By emphasizing interest rates, we do not wish to undermine the importance of building a strong institutional environment for investments in Latin America. Ambiguous laws, convoluted environmental standards, lack of regulation, and costly bureaucracies also need fixing. Rules need to be made more clear; contracts binding; and regulatory agencies better financed, technically savvy, and more independent.

3 De la Torre emphasizes that making the link between citizens' rights and the payment of taxes (especially income tax) is crucial to the legitimization of tax reforms in Latin America. He suggests replacing tax exemptions for low-income households with tax rebates to make transparent the connection between tax payments and citizenship. (See Augusto de la Torre, "La Reforma Económica y la Nueva Legitimidad," *Economía Exterior*, No.22, Fall 2002.)

4 Brazil is an exception, where tax revenues are 33 percent of GDP.

5 Trade liberalization has been too much a one-way street, with subsidies, quotas, dumping laws, and technical requirements (phyto-sanitary, environmental, and so on) making it difficult for exporters in Latin America to reach U.S., European, and Japanese markets.

Most citations and references are from Nancy Birdsall, "From Social Policy to a New Open-Economy Social Contract in Latin America," Working Paper, Center for Global Development, December 2002, and Nancy Birdsall and Augusto de la Torre with Rachel Menezes, *Washington Contentious: Economic Policies for Social Equity in Latin America* (Washington, DC: Carnegie Endowment for International Peace and Inter-American Dialogue, 2001). Additional sources on taxes and pensions include Carola Pessino and Ricardo Fenochietto (forthcoming), "Efficiency and Equity of the Tax Structure in Argentina, Brazil and Chile: Analysis and Policy Considerations," Working Paper, Center for Global Development and Inter-American Dialogue, and Anne Krueger, "Virtuous in Old Age: How the IFIs Can Help Prepare for Demographic Change," Speech at the Jackson Hole Symposium, Jackson Hole, August 27, 2004, International Monetary Fund. Data on the shrinking middle class in Brazil are from Waldir Quadros, *Brasil: estagnação e crise* (São Paulo: Organização Gelre and Centro de Estudos Sindicais e de Economia do Trabalho da UNICAMP, 2004), and Estudos Ipsos Marplan/EGM, 2003. Excellent recent analyses on the job situation in Latin America include Inter-American Development Bank, *Good Jobs Wanted: Labor Markets in Latin America*, Economic and Social Progress in Latin America: 2004 (Washington, DC: 2004), and International Labor Office, 2003 Labor Overview Latin America and the Caribbean (Lima: Regional Office for Latin America and the Caribbean, 2003).

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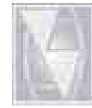

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