

MARKET VERSUS STATE

POSTCRISIS ECONOMICS IN LATIN AMERICA



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Market Versus State: Postcrisis Economics in Latin America

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• Summary •

The global financial crisis has reignited the fierce debate about the roles of the market and the state in modern economies. Latin America, in particular, revisits this debate every time it suffers an external shock. While some blame unregulated markets, others fault states' inability to design institutions or implement policies capable of neutralizing the negative impact of these shocks on output, employment, and social welfare.

As they emerge from the most recent crisis, Latin American economies need both—more market *and* more state. More market will enable them to exploit new opportunities through bilateral or multilateral trade agreements, and expand public-private partnerships. But “more market” also implies more competition, and in many of these economies, that will require better regulation and thus, more state. A more *intelligent* state, acting as a catalyst for development, could encourage creativity and foster entrepreneurship. The state must also play a greater role in creating the social protection networks required to reduce economic insecurity in a region where external shocks have become a recurring phenomenon.

As they emerge from the global downturn, Latin American countries should study its effects, and reexamine their economic policies from a dispassionate distance. By the time the next crisis hits, it will be too late to act.

• Introduction •

The current global financial crisis has reignited the debate about the role of the market and the role of the state in modern, open, globalized economies. It is now obvious that the current financial turmoil and recession are a result of market failures. It is also an established fact that regulatory agencies failed to detect imbalances and high systemic risks in the financial sector and that these failures have had a devastating effect on the world economy. In this sense, we have failure of both the market and the state. This result has fueled the heated debate (with marked ideological undertones) about what the state's future role should be to prevent new financial shocks of the magnitude suffered since 2007—and what role free markets should play in a postcrisis scenario.

In Latin America, this discussion has been going on for decades. Every time the region suffers the consequences of an external shock—and there have been five such episodes since 1980—many blame unregulated markets. Others point to a state that has proven unable to design policies or institutions capable of neutralizing the negative impact of external shocks on output, employment, and social welfare.

In a striking reference to this predicament, policy makers, gathered for a meeting of the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) in 2004, referred to the state in Latin America as being an “ill-fare state” rather than a “welfare state.” A disappointing description, given that only a few short years ago, in the first half of the 1990s, great hopes had been awakened; the structural reforms of the 1980s were finally bearing fruit, and the region was at last heading toward a sustained, solid rate of economic growth.

Any hope of maintaining that solid economic growth was dashed by the damaging repercussions of the 1997–1998 East Asian financial crisis. The pessimistic mind-set that “things don’t last” in Latin America took root with particular tenacity, reinforced by the weakening of governments that had been elected through free and fair democratic processes.

The cycle is being repeated. The first half of this decade showed strong growth, poverty reduction, lower inflation, and more solid public finances for the region. But this encouraging trend has been interrupted by the global financial crisis that began in December 2007. The resulting deep recession and high unemployment rates have once again provoked pessimism throughout Latin America.

Thus, the long-standing debate over how to transform Latin America’s economies has been revived. Some argue that the reforms of the 1980s had a neoliberal, pro-market slant, which caused increasing inequalities in the region, reduced investment, and consequently, fragile political systems. What was needed instead, they contend, was a stronger, more powerful state.

Others argue the reverse, viewing the reforms of the 1980s as timid and incomplete, unable to modernize the state by reducing the extent of its involvement in the economy and focusing its efforts on more limited tasks. Accordingly, what was needed was more market and less state.

Latin America’s economies were indeed transformed in the 1990 and 2000s by the implementation of previously untried, innovative economic and social policies. Yet the hugely negative consequences of the current crisis risk these new approaches being discarded and the whole cycle starting all over again.

I take the opposite view and argue that it is possible to learn from the successes and mistakes of Latin American economic policies of the past twenty years to draw lessons and apply them cumulatively and gradually to present-day conditions. The rich experiences of the past two decades constitute a wealth of social capital that leaders in domestic and international development can draw on to develop a more comprehensive road map of what must be done to achieve growth in Latin America similar to that experienced by the East Asian economies over several decades: one that is self-sustaining, with fewer inequalities, and a greater capacity for innovation. At the heart of this challenge is a critical examination of the changing role of the state and the market in Latin America’s recent experience.

• The Region From the 1950s to the 2000s •

The 1950s, 1960s, and 1970s can be characterized as a period of “more state” in Latin America. Through industrial policy, heavy investments in infrastructure and basic industries such as steel and energy, and increased investments in education and public health, the state was an active agent of development.

This phase of the region’s development succeeded in stimulating economic growth, which was plainly greater than what would follow in the 1980s and 1990s. However, the paradigm of import-substitution industrialization and protecting national industries worked better in larger economies such as Brazil and Mexico than in the rest of the region. There, any initial dynamism dissolved, mainly because of the limited scale of the smaller nations’ internal markets (Muñoz Gomá 2001).

In the 1970s, ECLAC encouraged a gradual opening of the region’s economies and their eventual integration into a common market. It also proposed state incentives focused on boosting the production of small- and medium-size companies. Through such policies, ECLAC sought to reduce the structural heterogeneity and inefficiencies that had long undermined Latin American economies (Hoffman and Torres 2008).

The reforms introduced in the 1980s were driven by the debt crisis and the need to adapt the region’s economies to globalization. They were further strengthened by the powerful pro-free market ideological offensive launched by the governments of Ronald Reagan in the United States and Margaret Thatcher in the United Kingdom and their counterparts in Latin America. By this time, the state had been identified as the problem and the market as the solution. As a consequence, state-owned companies were privatized, markets

deregulated, and external tariffs summarily reduced (French-Davis 2005).

The debt crisis of the 1980s forced successive financial adjustments that severely weakened the state's ability to act. Public investment was adversely affected, and resources for social protection were drastically reduced. In many of the region's nations, the civil service suffered salary cuts, which in some instances transformed it into a defenseless and demoralized bureaucracy. For many civil servants, the dictum of "real socialism" became a reality: "We pretend to work, and the state pretends to pay us."

This situation was exacerbated when Chile, Mexico, and Argentina put into effect the macroeconomic policies of automatic free-market adjustment, particularly a sudden opening of the capital account accompanied by fixed exchange rates. The three states successively adopted that noxious combination, and they predictably (Chile in 1982, Mexico in 1994, Argentina in 2001) experienced catastrophic results: overindebtedness of the state and the private sector; macroeconomic devaluations; recession; high unemployment; business failures; and a deep social crisis. The inevitable political consequences followed: a commensurate weakening of political institutions; rotating governments; a crisis of the party system; and lack of confidence in democracy where it had existed.

A broader perspective on the reforms of the 1980s should see beyond the financial crises fueled by mistaken macroeconomic policies. The opening of domestic economies triggered a powerful export dynamism and compelled increased efficiency in a significant segment of the production apparatus. The state gave up the responsibilities that it was carrying out poorly and that were draining resources away from social priorities or infrastructure modernization. Dormant entrepreneurial capacity was reactivated. Accompanied by a favorable external environment, the 1990s underscored the positive results of these changes, which resulted in vigorous growth. This growth was unfortunately interrupted by a new external shock—the East Asian financial crisis. (For further descriptions, evaluations, and measurements of the reforms, see Burki and Perry 1997; IDB 1997; ECLAC 1998, 2002; Easterly, Loayza, and Montiel 1997; Edwards 1995; Kuczynski and Williamson 2003; Ocampo 2004; and Stallings and Peres 2000.)

However, attributing a low growth rate solely to the effects of external shocks and mistaken macroeconomic policies provides only a partial explanation. A fuller account must include a discussion of institutional factors; as an

Inter-American Development Bank document put it: “In the region there is as much a deficit of the state as there is of the market” (IDB 2003).

I argue that a more integrated vision is required, one that lays out new areas and tasks for both the market and the state. It needs to take into account the successes and failures of public policy in the 1990s and 2000s as well as the new circumstances presented by deepening globalization. In the remainder of this report, I attempt to articulate this integrated vision.

• More Market? •

In Latin America today, the predominant belief is that the region's nations have relied too heavily on the market and that this overreliance is the source of their economic dysfunction. To determine whether this excessive reliance exists, it is useful to begin by acknowledging the market's essential, irreplaceable role—and by specifying how, when, and where the market should be placed in a subsidiary role. Conversely, it is useful to delineate the set of required roles that must ultimately be played by the state. The principal role of the market is to induce competition—that is, to encourage a more efficient economy that better allocates scarce resources, reduces costs, and constantly evolves and in so doing enables the private sector to find new opportunities for production and exports.

Latin American economies have advanced substantially in the direction of greater reliance on the market, deregulation, and lower external tariffs. The unilateral opening of these economies has been reinforced by a network of bilateral and multilateral free trade agreements (FTAs), along with ambitious agreements on subregional economic integration (Inter-American Development Bank and Ministry of Foreign Affairs of Chile 2009). A hemispheric free trade agreement appeared to be the next logical step, as a way for Latin American producers to gain access to U.S. and Canadian markets. The prospect of such access would allow the region to contemplate new scales of production and investment and to consider comparative advantages when competing with more productive economies (Da Motta and Rios 2009).

Resistance within some North American producer groups, however, to giving up massive state subsidies, particularly in the agricultural sector, reduced the U.S. government's room for maneuvering within the negotiations

for a hemispheric FTA. North American proposals for trade liberalization avoided the most substantive matters—protection of agriculture and anti-dumping legislation—and were limited to offering modest, gradual reductions of tariffs on items whose initial duties were already low or insignificant. It should be no surprise, then, that the region’s major countries, such as Brazil and Argentina, had little interest in this proposed “FTA lite” (Foxley 2002).

Conversely, most Latin American governments have been active and constructive participants in the multilateral negotiations, known as the Doha Development Round, that are intended to liberalize trade under the World Trade Organization. This support reflects a conviction that more open markets would benefit their economies. The negotiations, however, have stalled. Leaders of the G20 have pledged to complete the Doha Round, but in the meantime the failure to do so has given new impetus to the notion of market integration within the Latin American region. A proliferation of subregional groups—such as Mercosur, the Andean Community of Nations, the Central America Free Trade Agreement, and more recently the Unión de Naciones Suramericanas—have provided the space for “more market” within the region. But progress has been slow, and the current global financial crisis and recession have provided the excuse for some countries to resort, once again, to protection of their own domestic markets. In some cases, this protectionism has been accompanied by a new version of populist, nationalist, pro-state, and anti-market rhetoric.

Latin America has not learned how to profit from another dimension of opportunities offered by what economist Enrique V. Iglesias called “the second floor of the world economy”: the vast, largely untapped markets of India and China. Latin America has yet to develop a strategic orientation toward these new Asian markets. The countries that have recently done so, among them Australia and New Zealand—countries that, like those in Latin America, export natural resources—have expanded their growth potential in the medium term and have been less affected by the global economic downturn. Australian goods remain in high demand in China, whose economy, even amid the global financial crisis, is still growing at close to 7 percent a year.

Latin America also needs to achieve a greater reliance on the market through public-private partnerships that could improve health care and educational opportunities for the low- and middle-income sectors, which have been excluded from good-quality services in those areas. The relatively low tax burden in Latin America imposes severe limitations on nations’ ability

to provide these kinds of public services. The demand for higher quality services increases with income. The choice, then, is simple: Either raise taxes to satisfy demand, or open up the provision of services to the private sector, supplemented by subsidies so even the lowest-income populations can attain universal coverage. (For evaluations and measurements of the role of the state in Latin America, see Tanzi 2008.) I address this in more detail below.

Some Latin American countries are also expanding the role of the market by opening a system of concessions to the private sector to carry out public works projects such as the construction of highways, ports, and airports. Chile has even initiated an experimental program of allowing the private sector to build and run prisons. The results of this approach have been mixed. There have been a few resounding failures, forcing the state to resume its role as provider. And in many instances, it is premature to draw a final conclusion. But what is clear is that, given the limited availability of public resources, private concessions make it possible to proceed with investments that the state could not otherwise afford to undertake. When incentives to investment are well designed, the private sector responds rapidly and vigorously (Engel, Fischer, and Galetovic 1996, 2001; Vivallos 2003).

Two sectors of the Latin American population have been unable to take advantage of the opportunities provided by greater market access: poor farmers, who, because of an inadequate or nonexistent transportation infrastructure, cannot bring their products to the market; and small businesses, which are unable to regularize their property rights and use them as credit guarantees, as argued by Hernando de Soto (1989, 2006).

Along with increased reliance on the market, Latin America needs more competition in key markets that have been deregulated or privatized and that show clear monopolistic or oligopolistic tendencies. These tendencies occur in some countries in which consumers, who are at the mercy of a single or small number of providers, are charged excessive rates for energy, telecommunications, or other services. When one or two powerful companies whose fate depends on decisions about rates seek to reverse the allegedly arbitrary rulings of a regulatory agency, their approach is often to pressure the courts—an unnecessary measure that paralyzes investment. Pressure is also commonly brought to bear on the political establishment—an undesirable recourse that leads to corruption. These tactics impair the effectiveness and transparency of public decisions in a democracy. Recent experiences in Latin America illustrate dramatically what happens when transparent, reliable regulatory guidelines

are not established equally for all, along with instances when the absence of competition among providers renders even the best regulatory guidelines ineffective (Tavares de Araujo Jr. 2003; Lapuerta, Benavides, and Jorge 2003; Troya-Martínez 2006; Hilke 2006).

Latin American policy makers need to learn quickly about best practices in regulation and about legislation elsewhere that has proven effective in promoting competition in regulated sectors that provide basic services. The region also needs to strengthen the training of highly qualified and well-paid technical personnel from the state regulatory agencies, who will ensure that competition exists and that rules are applied fairly and consistently to these recently privatized activities.

The experience with regulation of the financial sector in Latin America has, surprisingly, been rather positive, particularly compared with the performance of the banks and nonbank financial sectors of the developed economies during the current financial meltdown. Latin American governments and legislators seem to have learned from past financial shocks. Their banks and other financial institutions did not participate, to any significant degree, in the opaque, unregulated markets for derivatives, hedge funds, and credit default swaps that underlie the collapse of financial markets in most developed economies. Their regulatory framework was significantly improved after their own experience with financial collapse in the 1980s. Thus, a note of caution must accompany the suggestion to learn from “best practices” of developed economies when it comes to regulatory norms. Learning from domestic experience about how to handle financial bubbles and crises is more likely to generate adequate regulation, it appears, than importing formulas from abroad.

• More State? •

The idea of Latin American countries being “ill-fare state[s]” is based on two assumptions. The first is that globalization increases economic insecurity, undermines social cohesion, and accentuates income inequality. The second has to do with the growing precariousness of the job market. Open markets and the resulting vulnerability to external shocks have been known to make the employment situation more unstable and uncertain.

There is no greater exercise in futility than engaging in these arguments intellectually, for they constitute deeply held sentiments that permeate the world of politics in Latin America. Some argue that these consequences are transitory or that they might fade away with more deregulation of the economy and the promotion of new liberalizing reforms.

My focus here is different. To take account of the problems in the region requires a significant adjustment in how we view the role of the state during the next stage of Latin America’s development. It is not a question of more state or less state but of a different kind of state—one that transforms itself to provide new and more effective responses to economic insecurity, insufficient job creation, and the precarious and temporary nature of much employment. The challenge consists, first of all, in refocusing the role of the state so the economy can create new, better-quality jobs; and second, in conceiving a welfare state adapted to new realities.

• The State: A Catalyst for Development •

During the phase in which industrialization increased in an effort to reduce dependence on imports, the state played multiple roles in Latin America's development. It was at once a regulatory state, an entrepreneurial state, and a pro-development state that actively promoted industrialization through subsidies, tax incentives, and tariff protection.

In its first stage, this strategy was widely successful, generating strong growth in the region. It furnished a sustainable industrial base for Brazil, Mexico, and, to some extent, Argentina. In countries with limited domestic markets, however, the state provided too much stimulus to artificial, noncompetitive industries that could not withstand the battering that accompanied the greater interdependence developing in global markets during the 1980s (Muñoz Gomá 2001).

This dilemma was particularly acute for small- and medium-size countries in the Andes and Central America. The opening of their economies evinced a production and export structure based almost entirely on natural resources. Empirical evidence shows, however, that it is unlikely for a country to achieve sustainable development for several decades without first diversifying its productive structure, adding value and technology to its natural resources, or entering into the competitive production of exportable manufactured goods or services (exceptions to this rule are Brunei and Iceland, and possibly Norway).

In fact, Sachs, Larraín, and Warner (2000) suggest that the greater an economy's concentration on natural resources, the less it tends to grow in the long run. In addition, empirical evidence suggests that in such cases, growth rates tend to be more volatile, with marked boom and bust cycles reflecting

strong and unpredictable fluctuations in the price of commodities, in the terms of trade, and in the region's capital inflows and outflows (Rodrik 1999).

This conclusion, however, needs to be placed in the context of the new conditions prevailing in the global economy. Technological change has acquired a dizzying pace; the life cycle of new products grows shorter and shorter; and globalized markets are more volatile, as are consumer preferences. Today, the kinds of products and services in demand are based more on knowledge and new ideas and less on physical capital and natural resources. By definition, the generation of knowledge and ideas proceeds at varying speeds, depending on whether countries have created the robust institutional framework needed to generate and utilize knowledge from a wide variety of sources, including governmental applied research centers, private industry, customers, suppliers, company employees, and potential new entrepreneurs (Cooke and Morgan 2000).

Knowledge can be applied to natural resources, manufactures, or services. The value added by knowledge-based innovations makes it possible to diversify the composition of production (and exports), starting from either natural resources or manufactures and services.

Conversely, problems of development cannot be solved solely by an entrepreneurial state. What we are dealing with here is a complex process of collective learning in an uncertain world and in uncertain markets. Nor does the fragmented market of neoclassical theory generate, all by itself, sufficient information and knowledge to enable a country to anticipate trends and get ahead of others in global competition. It is not so much a matter of discovering a "silver bullet" as it is a matter of forming networks that make it possible to develop a country's resources to the fullest potential through the cooperation of companies, research centers, universities, public agencies, and regional and local governments (de Ferranti et al. 2002).

In short, the new demands posed by global competition mean neither dismantling the state nor increasing its involvement in the economy, but restructuring and fine-tuning it for a new kind of function—something like a catalyst for development. New Zealanders, for example, visualize the state as providing a "light rain" that produces a green pasture, a newly inviting environment where others are tempted to sow seeds (OECD 2003).

A glance at the structures in place shows how unprepared Latin America is to compete in a knowledge-based society. Studies of leading private companies in some Latin American countries reveal structures of family ownership, with

a vertical and hierarchical internal organization marked by routine and repetitive practices. The watchword seems to be “Doing more of the same can’t hurt us.” These organizations are reluctant to dedicate resources to research and development that could generate new products, processes, and markets. Nor do they spend significant amounts on retraining personnel; continuing education and skill enhancement are clearly not a priority. So it is not surprising that the limited research and development performed in Latin America is generally carried out by public institutions and to a lesser extent by university centers, which often have little connection with commercial enterprises and their needs for innovation (Benavente 2009).

Moreover, systems of industrial promotion are often fragmented and lack coordination with each other. Far from being thoughtfully structured, they consist of superimposed layers of institutions and programs generated during different phases of development going back to the 1950s. The Chilean government, for example, operates more than one hundred programs to promote industry, agricultural development, small producers and farmers, and small- and medium-size businesses. The cumulative effect of these programs is barely noticeable. They are diffuse and duplicative, and they are easy prey for a limited clientele that survives by repeatedly accessing the same benefits, despite the fact that those benefits do not generate innovations in production and technology or increased productivity. To meet the demands of a knowledge-based economy and as a basis for competing globally, it is essential and urgent that state institutions be restructured.

• The State and the Knowledge-Based Economy •

The countries that have been the most successful in boosting their productivity and growth during the past two decades have continually evaluated their progress in reforming their institutions for development—adjusting designs, adopting better practices from other countries, and interacting constantly with users. Monitoring progress in these matters has a permanent place on the public agenda in Australia, New Zealand, Ireland, and Finland—to mention some of the most successful experiments of the 1980s and 1990s—as well as in South Korea and other East Asian countries (Yusuf 2003; Castells and Himanen 2002; Nieuwenhuysen, Lloyd, and Mead 2001; IDB and Ministry of Foreign Affairs of Chile 2009).

More than two decades ago, in 1985, Peter Evans, Dietrich Rueschemeyer, and Theda Skocpol stressed in a book that despite complaints and criticism about an omnipresent state and claims that it had retreated, the state, at least in developed capitalist countries, was still taking in and distributing a third to half of the gross domestic product (GDP). For the current Latin American economic situation, that book's title, *Bringing the State Back In*, continues to hold relevance.

Consider free trade agreements. They have opened up new markets, but that alone does not ensure that the participating economies can generate product innovation, new production methods, or permanent increases in factor productivity—all of which determine the ability to compete in these new markets. It is almost a cliché to state that technological change and globalization require advanced training for a knowledge-based society and that such a society requires economic institutions and agents coordinated through

networks. Some particularly successful countries combine these networks to form a national system of innovation (de Ferranti et al. 2003).

I am not referring here to theoretical approaches—research done at a desk. My experiences in the field studying the processes of generating ideas, mobilizing resources, and redesigning public institutions in small, open, market-friendly economies that adapt successfully to globalization—as in Finland, Estonia, Ireland, Australia, and New Zealand—give some sense of the importance of the state’s “return” to promoting development. In this context, it is not a matter of protecting industries but of helping them promote steady, permanent increases in productivity.

These experiences point to certain characteristics of state activity worth mentioning. Faced with an international division of labor in constant flux, the state must promote a process of permanent and continuous national learning with respect to changes and trends in world markets. The quality of education, which the state must protect and guarantee, constitutes the key to survival in a constantly changing global economy. Education must be the number one priority. High-quality education, sustained for decades and managed by the state, is behind the high growth rates of GDP in such countries as Ireland and Finland over the past two decades (Aho, Pitkänen, and Sahlberg 2006; Ferreira and Vanhoudt 2004; Bergin and Kearney 2004).

In the global economy, nobody survives by going it alone. Cooperation between public and private agents, and among companies, universities, and regional governments, is one of the keys to new ideas, technologies, and designs. Another is joint access to large-scale markets. These are the essential rules of the knowledge-based economy: networking, sharing ideas, and learning to work as a team. This principle is valid at all levels: national development strategy, locally, and within private industry.

The notion of “stakeholders” is pertinent here; that is, all those who share an interest in developing new products and markets and in innovating and incorporating new technologies and lines of production must be engaged in the network. Cooperation among stakeholders replaces the traditional concept of the individual entrepreneur facing a static market. The purpose of strategic dialogues among stakeholders is to share a vision of the future (IDB and Ministry of Foreign Affairs of Chile 2009).

With regard to key sectors and regions, it is essential to formulate questions about where those involved want to be in the future, what others are doing, and how to improve institutions so they can compete globally. For instance:

“What kind of Finland 2020 do we want?” was a question that the top executives of that country asked themselves during a three-week collective exercise that began in China, continued in California, and culminated with a group meeting in Helsinki. Their conclusion: “We are going to work together to become the number one 2020 Welfare and Knowledge Society.” In other countries, leaders are asking how the state can catalyze efforts to promote innovation in such areas as biotechnology, biomaterials, and staple and organic foods. They are also asking how they can detect new niches in international markets at the right time. These processes are stimulated by the “light rain” that originates in public agencies working in collaboration with research centers and private industry. Countries such as Ireland, Finland, and Australia have created models for stakeholders’ dialogue embedded in a modern and transparent state. The state facilitates the process under which the relevant social actors can come together to develop a national vision in key public policy areas.

If half the difference in per capita income is explained by an increase in total factor productivity—that is, by the capacity for innovation and technical development—it is essential to ask how the state can join in this process through public institutions coordinated in a national innovation system. The experience of Finland, Australia, and New Zealand is worth noting. They created national, regional, and local funds—initially made up of public resources—to support innovation. The money was allocated as grants and matched by private resources to stimulate research and development by private industry, universities, and applied research centers. The criteria for use of these funds were rewarding partnerships between academic institutions and private enterprise, including networking with advanced technology research centers in other countries.

In addition to coordinating a national innovation system, the state can and should intervene in other important ways to help achieve greater productivity. Among them: facilitating access to capital for new entrepreneurs; attracting foreign direct investment; stimulating the creation of productive clusters; and facilitating the transfer of knowledge. Let’s briefly consider each one, and how, in some instances, some states are leading the way.

- **ACCESS TO CAPITAL:** Availability of capital is the surest way to widen the base of entrepreneurial capability. In Latin American countries, the non-existent network of institutions to provide capital for the different stages

of new businesses is an impediment. In contrast, South Korea, Israel, Finland, Ireland, New Zealand, and Australia have put networks in place to keep capital flowing to entrepreneurial enterprises. Their innovation experiments have been successful.

- **FOREIGN DIRECT INVESTMENT:** The state has a central role to play in designing incentives to attract foreign direct investment in nontraditional categories that bring in new technological developments, new skills, and new markets. Ireland was especially successful in developing such a strategy in the 1980s through generous tax incentives that turned it into a platform for North American information technology companies operating in the European market.
- **PRODUCTIVE CLUSTERS:** The state can also help stimulate the creation of productive clusters in local communities and regions. Based on their strengths and weaknesses, regions need to identify niches in the international economy in which they can best specialize and compete successfully. Using public funds to promote partnerships at this level has also proven to be a powerful instrument for promoting innovative economies at the local level through the formation of clusters (Cooke and Morgan 2000). Another joint task for the public and private entities of each region is to design a plan—suited to the region’s comparative advantages—to improve the qualifications of its workforce.
- **TRANSFER OF KNOWLEDGE:** The state must also play the role of advance guard in internationalizing the processes of generating new knowledge and ideas that will ultimately produce wealth for a country. Entering into partnerships with top research centers in more advanced economies; learning the best practices of international capital risk funds; providing educational exchanges on a large scale (especially at the graduate level); and promoting the study of English—these are only a few of the tasks essential for open economies to compete successfully in a globalized world.

• The State: A Catalyst for Social Protection •

Along with bringing actors together, providing the right incentives, and developing good regulations and control mechanisms, a modern Latin American state should contribute to improving the declining welfare systems of the region and to advancing toward a society in which the public and private sectors participate in the national welfare systems.

The Latin American countries with more advanced welfare states—especially the Southern Cone countries, Costa Rica, and Colombia—established them in the 1960s and 1970s, modeling them on the institutions developed by European countries after World War II as mechanisms of social protection. European social democracies understood social protection for workers as revolving around the workplace (Esping-Andersen et al. 2002). In the prosperous 1960s and 1970s, Europeans enjoyed job stability and strong economic growth. Unions sought to perpetuate that by protecting existing jobs through legal impediments—in some countries, union approval was required before a worker could be laid off—or through the imposition of high costs on companies that did lay off workers. Also, the practice of negotiating salaries by sector or occupational type was established. The idea was for workers in high- and low-productivity companies to show solidarity and negotiate salaries jointly, thus reducing disparities in income between the two groups.

The social protection system was characterized by generous retirement benefits (it is estimated that, in Italy, after basic needs are met, pensions generate a 30 percent surplus, which is then used to sustain an informal family support network; Esping-Andersen 1999), unemployment insurance, and universal coverage extended to provide education and health care. This kind of welfare state requires the population to accept a high tax burden, typically more than

double that prevailing in Latin American countries. The European middle classes accepted that burden because they were receiving the obvious benefits of social protection against unforeseen events and they had access to universal coverage for education and health care, often free and of equal quality regardless of socioeconomic status. Added to all this was job stability for the head of the household.

With globalization, these favorable circumstances began to crumble. The first signs of change occurred in the nature of work and employment (Ferrera, Hemerijck, and Rhodes 2001). The need to constantly adapt to the changing conditions of world markets led to a high rate of job turnover. Willingly or unwillingly, people left their jobs and sought new employment. Temporary and part-time work became more widespread. International financial shocks created cycles of employment and unemployment, often punctuated by long periods of seeking new, stable work. In some countries (Great Britain, Finland, and Spain), it takes a worker who has not completed high school an average of seven years to find a new, permanent job after successive episodes of being unemployed or holding temporary, short-term jobs. The average for such unemployment in Germany, France, Sweden, and Belgium is three to five years, according to estimates by the Organisation for Economic Co-operation and Development (Esping-Andersen 2001). In the meantime, the long-term unemployed migrate among countless temporary and part-time jobs.

These profound changes in the nature of employment in Europe have led to a breakdown in the traditional mechanisms of protection. The welfare state protects the “insiders”; that is, workers with permanent jobs in traditional enterprises, including public-sector companies and the civil service. This labor force makes up the core of the membership of unions, which defend the status quo, depriving those in the new mobile workforce—who gradually are becoming a majority—of the benefits accorded union members. This situation creates a crisis for the traditional welfare state and consequently backfires on unions by weakening them.

In addition to the volatility of employment, a second sign of change connected to globalization has occurred in European family structures and, as a result, the household economy. The number of married couples is decreasing, and the number of single-parent households is growing. A large number of female-headed households remain unprotected by the social welfare network. These fragile households are especially vulnerable to the economic cycle, and childhood poverty is more widespread.

These factors, along with demographic changes and rising costs, explain the crisis of the European welfare states and the initiatives they have taken—the success of which varies from country to country—to adapt to the new conditions of employment and of the household economy brought about by globalization. The countries undertaking reforms are forced to adopt a less onerous tax burden more compatible with stimulating employment and investment (Gilbert and Van Voorhis 2003).

What do the upheavals in the traditional welfare state established by European social democracies have to do with Latin America? Earlier, in the period of import substitution, Latin America had tried to copy the institutions that had given rise to this type of welfare state. But from the start, there was an imbalance between the transplanted welfare state and the unique labor market and nature of the family in Latin America. It was wishful thinking to consider the Latin American workforce of the 1960s and 1970s as homogeneous, with stable jobs and strong union organization, as in Europe (Ramos 2003). Nor was there in Latin America a consolidated family structure headed by a breadwinner with a stable job and income protected by a labor union, as was the case for Europe in the 1960s and 1970s. During that period in Latin America, there was already a preponderance of self-employed workers and individuals who held temporary or sporadic jobs, combined with high unemployment among women and youth. Wage agreements, welfare programs, and social security arrangements followed the European model by being directed toward the segment of permanent and organized workers in the public sector, state-owned enterprises, and a few big private companies—while leaving the rest of the labor force without even average coverage.

When we add to this situation the high incidence of female-headed households, which are particularly economically vulnerable, it is easy to appreciate the gap between traditional European-type mechanisms of social protection and the reality of jobs and households in Latin America. In Chile, for example, one of every four families is headed by a woman, and yet only one of every five women in the quintile of lowest income has access to a job—and that job is often temporary or precarious. Despite notable progress in reducing poverty during the 1990s (Foxley 2003a, 2003b), things are only slightly better in the top quintile, where one of every two women heading a household has access to a job. The unemployment rate for women in the lowest quintile is several times as high as for those in the top quintile, which has the highest degree of job protection. This gap between the design of social protection networks and

the reality of a heterogeneous, unprotected labor market is at the root of the malaise, or “ill-fare state,” that permeates Latin American societies.

Herein also lies the source of many inequalities. Take education. Over several decades, Latin American countries have tried to extend the coverage of their public education systems in line with the European model. These efforts have been followed by reforms intended to improve the quality of primary and secondary education (Puryear and Brunner 1994). The results, however, when measured by achievement tests, show enormous disparities in performance according to socioeconomic stratum, with stagnation in the lowest-income segments (Cox 2003).

Such findings illustrate the need to refocus the welfare state in Latin America. The equalization of opportunity throughout the educational system—which would mean equal access to good jobs for *all* young people, regardless of socioeconomic background—will not occur unless several types of empirical data are taken into account. A child’s cognitive ability is determined in the first five years of life. The home environment of children in the lowest-income households is characterized by economic insecurity and traumatic episodes—whether emotional or involving sheer survival—made worse by the economic shocks that Latin American economies frequently suffer (Raczynski, Serrano, and Valle 2002). The first effect of an economic crisis is often the unemployment of the head of the household. The mother really has no access to employment while her children are of preschool or school age. This is largely because of three deficiencies in Latin American social policies: overly rigid work rules that make it hard for women to obtain part-time jobs; the lack of proven work training programs for female heads of households; and an inadequate system of providing for children between the ages of one and five in preschool day care centers, kindergartens, and nurseries.

Compare that to the situation in the Scandinavian countries. Those countries, notably Denmark, turned their welfare states into vehicles for equal opportunity. They established a system of universal child care coverage for the critical first five years of life, with highly qualified caregivers to stimulate children’s social and cognitive development. At the same time, labor regulations were revised, making it possible for 75 percent of female heads of households to hold permanent part-time jobs (Ferrera, Hemerijck, and Rhodes 2001).

These examples demonstrate why, in the area of social protection, Latin America needs more of the state, and why the state should concentrate on addressing the vulnerabilities of the lowest-income sectors in the region that

globalization seems to accentuate. The stakeholders—the state, labor unions, and other actors involved in labor markets—must work together to redesign the institutions of the welfare system and the respective mechanisms of social participation and dialogue. The system can no longer be limited to serving the “insiders”—the workers and employees of the modern organized sector—but must also include the “outsiders” who constitute the majority. Social cohesion must be strengthened by confronting inequality at its roots—that is, the situation of women and children in the most vulnerable households of the low-income sectors.

• Private Partnerships for Social Protection •

It is of utmost importance that any redesign of the welfare state in Latin America include a reexamination of public-private partnerships, with an eye toward increasing the private sector's involvement in providing basic social services. In this way, the design of the social welfare state would take a different path than in Europe or the United States.

In Europe, the success of state-provided universal coverage for basic services was made possible by the prevailing high tax burden. That is something that will not be achievable for Latin American countries—at least not in a reasonably short period of time.

In the United States, contrary to what is usually claimed, access to basic services and social protection plans is not significantly different from what exists in continental Europe. The difference is that in the United States, a significant proportion of these services is provided by private entities, such as insurance companies, and paid for out of the family budget. Thus, the tax burden is significantly lower than in continental Europe, but the final cost for families is similar, as table 1 shows with respect to the United States and Sweden.

The problem in Latin America is that the region designed its welfare state institutions following the European model, but with a tax base below even that of the United States as percentage of GDP. That flawed combination virtually guaranteed that universal coverage for basic services could not be achieved. These basic services are often underfunded; furthermore, the civil servants who manage them are poorly paid and have no incentive to improve the coverage and quality of service.

TABLE 1. **Public and Private Spending on Social Protection, Sweden and the United States**

AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT				
Type of Spending	Sweden		United States	
	1990 ^a	2001 ^b	1990 ^a	2001 ^b
Public social spending	33.1	34.1	14.6	15.7
Tax spending	0.0	0.0	1.3	2.3
Private spending education	0.1	0.2	2.5	2.1
Private spending health	1.1	1.3	8.2	8.1
Private spending pensions	1.8	2.1	3.0	4.7
<i>Total spending on social protection</i>	35.5	37.7	29.6	32.9

AS A PERCENTAGE OF HOUSEHOLD SPENDING		
Type of Spending	Sweden, 1990 ^a	United States, 1990 ^a
Private spending on education, health, pensions	2.7	18.8
Spending for day care	1.7	10.4
Total private spending (percentage of household expenses)	4.4	29.2
Taxes	36.8	10.4
Private spending plus taxes	41.2	39.6

Sources: ^a Esping-Andersen (1999, 177). ^b Data from the Organisation for Economic Co-operation and Development: Social Indicators 2005, Education at a Glance 2004, OECD Indicators.

Note: The numbers for Sweden 1990 for spending on social protection as a percentage of gross domestic product add up to 36.1 percent in the original source.

One obvious question is: Why not embrace the European option in its entirety and raise the tax rate in Latin America to the levels of France, Germany, and the Scandinavian countries? There are three reasons that this is not feasible. First, the institutional apparatus for handling taxes in Latin America is deficient, particularly when it comes to curbing tax evasion. In practice, the major tax burden falls on the middle sectors of workers with stable employment. These sectors, which already constitute the main steady taxpayers, resist

raising taxes because, unlike their European counterparts, they do not see the benefits that such a sacrifice of income brings in terms of universal health care; high-quality public education; and protection from economic shocks, such as prolonged unemployment and other catastrophic events.

Second, high-income groups are politically opposed to raising taxes. They exercise influence through many channels, including powerful lobbies in national legislatures, whose representatives often depend on the contributions from these well-off business sectors for reelection.

The third reason is the greater relative weakness of Latin America when it comes to competing effectively with the countries of Asia, Central and Eastern Europe, and Oceania in attracting foreign capital, particularly to new, technologically sophisticated activities. Given Latin America's political instability and unpredictability concerning the rules of the game for foreign investors, the region has had to make do with smaller tax burdens on the public than those of developed countries, and even of those of stable, developing Asian countries.

The way out of this vicious circle is for the state to modernize and develop a new relationship with the private sector. The state would concentrate on the essential tasks of attacking extreme poverty and reducing inequality, while providing incentives and regulations to foster public-private cooperation. The private sector would assume the task of providing some of the basic services previously handled by the state. Extensive state reform is necessary for this public-private partnership to work. The goal of the reform would be to strengthen transparent, predictable public institutions capable of developing good socioeconomic policies. Such reform, however, takes time and requires a high degree of political consensus, which is often lacking at the outset of the reform process.

Chile is one of the countries in Latin America that has made substantial progress in this direction, as shown in table 2. Its national social spending, including the part that is privately financed, amounts to 26.4 percent of GDP—not significantly lower than that in some developed countries and close to the United States' social spending of 32.9 percent of GDP as noted in table 1.

This path, however, brings with it new questions and challenges. Basic services provided by private entities tend to cost considerably more than those provided by the state and their quality is generally higher. But if access to these privately provided services is not made equal and independent of the

TABLE 2. **National Social Spending in Chile, 1990, 2001, and 2005**

PERCENTAGE OF GROSS DOMESTIC PRODUCT				
Type of Spending	Sector	1990 ^a	2001 ^a	2005 ^b
Health	Public	1.9	2.7 ^c	2.6 ^c
	Private	2.2	3.1 ^c	3.2 ^c
	Total	4.1	5.8 ^c	5.8 ^c
Housing	Public	0.9	0.9	1.0
	Private	3.8	3.5	4.5 ^d
	Total	4.7	4.4	5.5
Social security	Public	5.6	5.4	4.8
	Private	0.4	1.4	1.8 ^e
	Total	6.0	6.8	6.6
Education	Public	2.4	4.1	3.8
	Private	1.6	3.2	3.1
	Total	4.0	7.3	6.9
Subsidies	Public	0.6	0.6	0.7
	Private	0.0	0.0	0.0
	Total	0.6	0.6	0.7
Other social spending	Public	0.5	1.0	1.1
	Private	0.0	0.0	0.0
	Total	0.5	1.0	1.1
<i>Total</i>	Public	11.9	14.7	14.0
	Private	7.9	11.2	12.6
	Total	19.9	25.9	26.6

Sources: ^aArellano 2004. ^bDirección de Presupuestos, Ministerio de Hacienda, Public Finance Statistics 1996–2005 (www.dipres.cl/publicaciones/finanzas.asp). ^cWorld Bank, Human Development Indicators, 2005. ^dCentral Bank of Chile, National Accounts of Chile 2003–2006 (www.bcentral.cl/publicaciones/estadisticas/actividad-economica-gasto/aeg01c.htm). ^eSuperintendency of Pension Fund Administrators (www.safp.cl/safpstats/stats).

ability to pay, the result could be increased inequality. Therefore, an essential component of this approach would be a complete reengineering of state subsidies to focus on segments of the population unable to pay for privately-provided services. Incentives and competition among private-sector providers of basic social services are necessary to reduce the cost for the users of these services. Another component would consist of effectively regulating the quality and access of these privately provided benefits, along with ensuring that their design does not discriminate against any social sector, least of all the lowest-income groups. The process I describe would transform a welfare state into a welfare *society*, one in which the task of broadening the system of social protection would be shared by the state and a wide gamut of private-sector and civil society organizations. This is a fascinating field that is ripe for experimentation. International organizations could accelerate and build up this process by training personnel, disseminating best practices, and making available to Latin American countries institutional blueprints that have proven effective elsewhere.

• Conclusions •

The debate over the path followed by Latin America in the past two decades has often been misplaced. The meager results of the second half of the 1990s, and those since the current global economic crisis began, have led to mostly fruitless discussions about whether the reforms were the right ones or were, in fact, counterproductive. The “ill-fare state” has rejected the “Washington Consensus” or, in its most radical iteration, opposes globalization itself. At this juncture, the ground would seem well prepared for nostalgic visions of the past or even the reemergence of earlier populist-nationalist discourses, with authoritarian undertones.

The root of the malaise is to be found in the new vulnerabilities arising from globalization, which, given its history, are particularly relevant for Latin America. There have been profound changes in the nature of employment in the region, with a shift toward temporary, part time, or occasional positions. Job turnover has accelerated. Changes in the family structure are making single-parent households headed by women more common. The barriers women face in gaining access to work make such households especially vulnerable. Childhood poverty is growing more acute. As a hindrance to the ability to learn and consequently to the academic performance of children from low-income households, it is a stark reminder of how poverty is perpetuated from generation to generation.

Accordingly, the reformulation of the role of the state should create a new type of welfare society, one in which policies easing access to work for women and other vulnerable groups are a priority, in addition to a pro-child social policy that emphasizes the preschool years. This refocusing must also seek to extend coverage for basic social services—education, health, and housing—until it is

universal. The limits of the fiscal capacity of Latin American states make it imperative to explore the role of the private sector and civil society organizations in providing social services to complement those offered by the state. Chile is one country that has made significant progress in this direction.

It is too early to evaluate the results of such policies. The reform of institutions charged with providing basic social services is a new development for Latin America that should be closely monitored by international organizations for distortions (for example, oligopolistic market trends or high costs that automatically exclude the lowest-income groups), as well as make available the experiences of best practices from more advanced countries.

My answer, then, to the question of whether Latin America needs more state or less state is that the region needs radical change in how the state and its institutions function. The task ahead is to transform the state so it can effectively address the underlying problems created by the “ill-fare state.”

Another aspect of the same challenge is the need to create permanent jobs of good quality within the context of volatile global markets and financial fluctuations. This is the most difficult task. It consists of making the transition away from the notions of “development from the state” and “development from the market” and toward the concept of a hybrid, innovative economy and a knowledge-based society. This will require the development of the state’s capacity to coordinate public-private efforts and to connect these efforts with the institutions that generate ideas and knowledge. Policy makers and practitioners need to break down barriers between airtight compartments: public institutions and private enterprises, universities, applied research centers, production sectors; regions and their influence on global markets through clusters; and international knowledge centers and their relations with countries’ export industries. Breaking down these barriers will also entail a new educational environment to produce a better trained workforce.

As the catalyst of a knowledge-based economy, the state should take an active role beyond negotiating free trade agreements at the international level. The states of Latin America should move on to building strategic alliances with countries that in the past two decades have succeeded in taking advantage of globalization by stimulating innovation and diversifying their productive structures. The examples are well known, with Australia, Finland, Ireland, Israel, New Zealand, and South Korea among the most prominent. At some point during the past twenty years, the leaders of each of these countries

either saw their main markets collapse or faced macroeconomic crises similar to those being experienced today in Latin America. They had the foresight and the fortitude to turn away from the institutions of their “ill-fare state.” In so doing, they reinvented the state’s way of relating to a variety of agents of development and increased the level of cooperation among key social actors participating in the policy-making process. This, in turn, contributed to setting in motion endogenous processes that increased productivity, innovation, and international competitiveness.

Such strategies fueled the creation of better-quality jobs that, in the end, strengthened the cohesion of society. And in the process, a new culture emerged in these countries. Key strategic actors do not work alone but are networked. Cooperation and trust are cultivated. The acquisition of knowledge is rewarded. Public policies have also changed. Governments in these successful countries have learned to encourage creativity and to foster entrepreneurial capability, just as a “light rain” helps new ideas sprout. In Latin America, the transition to these new forms of the welfare state, and new ways for the state to function, can be facilitated by working with international organizations attentive to such developments in the advanced countries. The region’s rich experiences with economic reform over the past two decades—both the successes and mistakes—can also provide important lessons, not cause for absolutist theoretical arguments.

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