

Beyond the Washington Consensus: A new job-based social contract in Latin America

“Más allá del Consenso de Washington: nuevo contrato social en AL, basado en el empleo”

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In the 1990s Latin America firmly embraced the economic reform package that has come to be called the Washington Consensus. The policies emphasized stabilization of prices to return developing countries to a path of sustainable growth—and structural adjustment measures to make economies more efficient and competitive. But after more than a decade of open market reforms and renewed democratic politics, there has been little growth or social progress in the region, causing a spiral of anxiety and deep frustration across countries. Economic activity in the last five years grew by only 2.4 percent on average, compared to 3.8 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 by *Latinobarometro* show Latin Americans tired of fiscal austerity, record high unemployment, and stagnant wages, and resentful of privatization and other so-called Washington Consensus reforms.

This growing anxiety reflects in part the challenges brought about by globalization. But it also reflects the fact that the benefits of reform have not been shared by all. Although increased public social spending in the 1990s did benefit the poor to a degree, the economic reforms of the Washington Consensus benefited mostly the already rich and well educated, without generating either growth or jobs. The resulting 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.

The results of reform have sparked a heated debate among economists and policy makers on the shortcomings of the Washington Consensus—whether the reforms are to blame for the poor growth and social performance in the 90s, and where some of the flaws in the reform package might reside. In this article we suggest that the main problem in the original consensus was the absence of any concerns with the sequencing of proposals and how that would impact the results in terms

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of jobs, growth, and inequality. We highlight a key area of reform missing—labor markets—and raise questions about the problem of lagging labor reform for the equity implications of the other structural reforms. Finally, to bring back attention to policies that would ensure job creation, we look beyond the Washington Consensus to a new open-economy 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; taxes and expenditures that are more progressive; job creation and protection of workers’ rights; and increased access to global markets, including through regional collaboration.

POOR AND MIDDLE-INCOME HOUSEHOLDS ARE FALLING BEHIND

Economic insecurity is hard to avoid in today’s open economies. But three grim realities in Latin America suggest the need for greater attention to the labor market problem in most countries, and the need for a new, politically visible and more explicitly “fair” job-based, open-economy social contract.

First, job growth has been extremely weak, increasing insecurity among middle-income households. Jobs and the labor market were not part of the reform agenda of the 1990s, and in retrospect, they were surprisingly absent from the political discourse. Efforts to quantify the extent of different reforms in the region put labor reform last and least, even by 2005. But recent surveys of attitudes indicate that lack of jobs and low wages are now the main concerns in Latin America—ahead of corruption, crime, and other social problems.

Labor market trends are cause for concern. Unemployment has risen from around 5 percent in 1990 to 11 percent in 2003, the highest level ever recorded in the region. Unemployment rates were persistently high throughout the decade, even when economic growth picked up early on. At the same time, 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.

Job creation has been very weak, and 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 a year, failing to keep up with the rate of growth of the working-age population. During the same period, many countries registered 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. Everywhere a large informal sector persists —where labor productivity is low and workers lack minimal protection and benefits.

Finally, evidence from household surveys suggests a 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 versus 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 prospect of going on to complete post-secondary schooling.

Second, middle-income households are not “middle class” at all, but actually rather poor. In the last decade 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.

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. The median level of education among Bolivian adults is still below two years. In Argentina, it is just above five years – that is, incomplete primary schooling.

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).

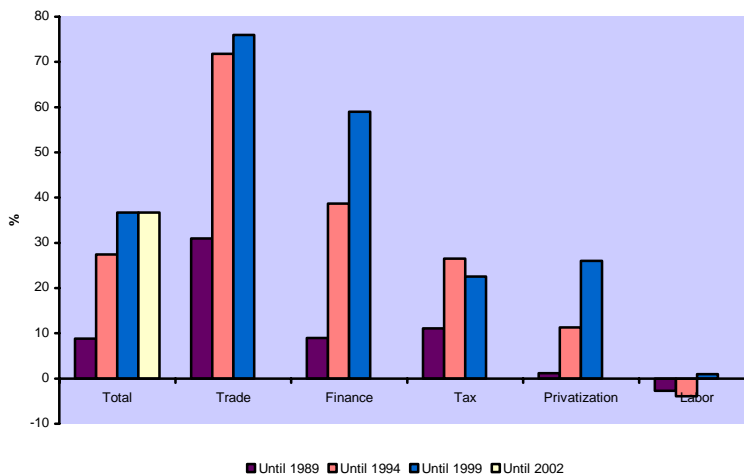
Third, although middle-income and poor households benefited greatly from reduced inflation, they were squeezed by the structural reforms of the 1990s. Reduction of expenditures, the write-off of debt (including with privatization proceeds) and steadier monetary and exchange rate policy reduced inflation 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 small in terms of growth, and largely concentrated among those with higher education and initially higher assets.

MISSING: LABOR MARKET REFORM

Labor market reform has lagged other reforms in Latin America (see chart), 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. Labor markets in the region (with the exception of Chile and by some measures Uruguay) are overregulated and very inefficient, with rigid labor practices favoring a small group of skilled workers over the majority of young, female, and unskilled workers.¹ Labor rigidities became even more binding with the loss of real wage flexibility in the 1990s, as the policy crutch that inflation had (ironically) provided disappeared.

Progress of Reforms in Latin America
(extent of reforms as % of total possible reforms)



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

In retrospect, the failure to deal with labor market rigidities probably undermined the success of trade and capital market openings, and of privatization. The impact on productivity and investment growth of those reforms was modest for many reasons, including the failure to avoid exchange

¹ While job security is less protected in Uruguay (e.g. mandatory transfers to workers are low, etc.), total costs of labor regulations are still relatively high—well above Chile and most developed countries—mostly because of high payroll taxation (social security contributions).

rate appreciation. Labor rigidities probably compounded the problems, for example (according to IMF and IDB studies) reducing firms' capacity to adapt to changes in the economic environment and making adjustment to the financial and other shocks of the 1990s more difficult.

Labor market rigidities also undermined job creation, so that the effects of other reforms were not only less efficient than they might have been, but less politically acceptable. In societies that start with high levels of inequality and highly segmented labor markets, new market opportunities are not likely to reach those without education and financial and other assets. Countries in the region that liberalized other markets but not labor saw increases in the size of the informal sector but not in wages or productivity, as the cost of capital but not the cost of labor in the formal sector fell. Probably because skilled but not unskilled labor tends to be complementary to capital in production, the demand for skilled labor in the formal sector increased much faster than the demand for unskilled labor, contributing to the widening gap in the returns to higher vs. secondary and primary education, and the widening wage gap between high- and low- paying jobs.

In many countries (including Argentina, Peru, Colombia, and Brazil), efforts to address labor rigidities were limited to the introduction of partial reforms such as temporary and fixed-term employment contracts with no benefits or incentives for training. The results have been more distortions and inequalities (e.g., greater wage gap between protected and temporary workers, reduced access and mobility to higher quality jobs by the young, women and unskilled workers) without the benefits of increased employment or reduced unemployment.

THE ELEMENTS OF A NEW SOCIAL CONTRACT

In crafting the social contract, we bring together three elements related to domestic policy, and one to policies of the advanced economies. This 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 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.

First, an open-economy social contract implies a new emphasis on job-creation and protection of workers' rights. The low-income status of supposedly middle-income households in most countries is caused by the failure of growth to generate formal sector jobs. Labor markets in the region, though highly regulated, fail to protect the great majority of workers. Regulation focuses on job security not on rights of association or collective bargaining that would allow workers to negotiate directly with employers. There is little or no public support during unemployment spells—since few countries have society-wide

unemployment insurance schemes. Ironically, severance payments are a costly regulation for workers. Applying only to those covered by full-benefit contracts in the formal sector, they are unrealistically generous, leading employers to find ways to avoid paying them, undermining job creation, security, and quality.

A social contract that is meaningful for middle-income households can no longer ignore the “jobs” problem. A new more 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. The emphasis should be on protecting job mobility not job security and the rights of all workers. It means taking into account that jobs are not only about income but also about dignity and a place in society.

Protecting job mobility need not rely on unemployment insurance of the type common in the richest economies, which requires greater capacity to finance counter-cyclically than most have at the moment. It 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. A collective or solidarity scheme funded by employers and the state pays benefits (partial insurance) to workers with insufficient funds in their individual accounts. 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.

In addition, the collective bargaining rights of all 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.

The political constraints to labor reform in Latin America are daunting. But politics were never said to be an impossible barrier to reform in areas that the development community and government officials believe are really important such as macroeconomic stabilization and open markets. With the exception of Chile, labor laws in Latin America are the most restrictive of any region. There is certainly room to make labor markets more flexible and dynamic (and improve the lot of unskilled workers) within the existing political constraints.

Second and also central to the social contract is a radical fiscal policy aimed at creating a strong fiscal base and lower interest rates. Above all, that 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 several years to come. More favorable economic conditions recently have allowed many governments to strengthen their fiscal positions. But public debt in Latin America remains too high—well above the 25 to 30 percent debt-to-GDP ratio considered sustainable over time for emerging markets.

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. Its positive impact on the ability of businesses to borrow would encourage the investments and growth that create new jobs.

In addition, 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 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.

Third, an open-economy social contract requires a fair fiscal system that makes taxes and expenditures more progressive. On the tax side, there are at least two issues. One is that 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. Despite various exemptions on such basic necessities as food and medicines, the value-added tax, excise, trade, and other consumption-based taxes tend to be regressive. They collect a higher percentage from the incomes of the poor than the rich, in large part because the poor spend a larger share of their income than the rich. Payroll taxes—with a rate more than 15 percent in most countries—are high (further undermining creation of jobs in the formal sector) and also regressive. Moreover, like the VAT, the payroll tax is invisible, 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.

Implementing more visible and more progressive tax policies does not require raising marginal tax rates. It requires first and foremost reducing evasion (especially of income and wealth taxes), eliminating loopholes and exemptions, and improving tax administration. It entails lowering payroll taxes, which would increase collection from both payroll and value-added taxes (through reduced evasion) and help reduce informality levels. 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. (Brazil is an exception, where tax revenues are 33 percent of GDP.) So a key objective in the region should be to increase overall revenue collection while avoiding worsening regressivity.

On the expenditure side, most countries in the region do manage a distribution of expenditures, especially on social investments, that is more progressive than the distribution of income. But in some countries, major areas of expenditures such as pensions for civil servants and the military are both inefficient and unfair. In Mexico at the end of the 1990s future obligations of the civil service pension system were estimated to be as high as a third of the reformed system. In Brazil, the deficit on the civil service system, which only covers 10 percent of pensioners, constitutes around 3.5 percent of GDP. As IMF's Anne Krueger highlighted in a recent speech, 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 in 2003 are a step in the right direction, they save only about 0.2 percent of GDP. Some of these obligations will in the end be covered by future taxpayers. That means poorer workers are likely to have to subsidize more privileged workers.

Finally, a social contract requires 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 better 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. 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.

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 adapted to the opportunities and vulnerabilities of open economies and focused heavily on jobs and growth. This implies first and foremost an emphasis in the labor market on encouraging worker mobility rather than protecting jobs; a radical fiscal management, with tax and expenditure reforms; 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.