*The Political Challenges of Economic Reforms in Latin America*

## Overview of the Political Status of Market-Oriented Reform

Political support for market-oriented economic reforms in Latin America has been, on balance, encouraging, although its durability is at risk. The conclusion of a 1996 report by the Inter-American Development Bank (IDB) remains valid: "The process of structural reform has proven to be sustainable. In almost all countries of the region, the reforms survived periods of economic crisis and changes in government."[1] The results of presidential elections in major countries of the region during recent years support this favorable assessment.[2] In the largest country of the region, Brazil, a reform-oriented leader, President Cardoso, was elected in 1994; according to the latest polls, he is likely to be reelected in October 1998. In Mexico, the ruling PRI party selected a pro-reform presidential candidate, Ernesto Zedillo, in 1994, rather than revert to the more economically conservative wing of the party. And the severe economic crisis that hit Mexico in 1995 did not bring about a reversal of previous liberalization policies. In 1995, both President Menem in Argentina and President Fujimori in Peru won reelection after pursuing aggressive and successful economic reforms designed to stop hyperinflation. Even in countries in which opposition parties have replaced reformist administrations, as in Bolivia in both 1993 and 1997, the new administrations campaigned to improve, not to reverse, the basic economic policies. In short, the evidence in Latin America in recent years is that broad political support for the market-oriented reform agenda has been reasonably robust.

Nevertheless, there is substantial risk that political pressures will lead to a slowdown in the process of economic reform throughout the region. As a general proposition, the reform process is easier at the beginning. This is especially true if an initial economic crisis has generated a strong political will to change. But reform becomes more difficult when the initial crisis is overcome and when the reform threatens deeply rooted interests and requires more thorough institutional change.

A slowdown in reforms is not, however, the only danger. The risk of a backlash against the currently dominant economic model and of backsliding in key areas of reform should not be underestimated. Over time, the gap between expectations and reality may widen. Initial progress in reform has generated high expectations that in many countries have not yet been matched by growth in real wages, employment, and public services. Those who have been hurt by the reforms to date may remain more vocal—and hence politically potent—than those who have won. Rent-seekers may become more dangerous to sustained reform than the political opposition itself. For all of these reasons, the risk of significant policy reversals must be taken seriously.

Perhaps the most important danger for market-oriented economic policies is that many people, especially the politically potent middle classes, seem to feel increasingly insecure in several dimensions. Some reforms have contributed directly to insecurity for certain groups. Trade liberalization has exposed many firms to more intense competition and hence to pressures for cost efficiencies, although its impact on income distribution in the region remains unclear (see box 1).

BOX 1. OPENNESS AND INEQUALITY

The relationship between economic openness resulting from trade liberalization and income inequality is far from clear in Latin America.* On the one hand, those best able to take advantage of the new economic environment have so far gained the most from economic openness. They include modern firms that can compete in the export market, wealthy individuals who can pursue new investment opportunities, and professionals who can sell their skills in the global marketplace. On the other hand, the very high degree of income inequality in Latin America is an historical legacy of closed economies that were based on the exploitation of natural resources and on import-substitution policies. These systems created massive rents, suggesting that perhaps the most important source of income inequality has been the capture of these rents by elites. Since market-oriented liberalization destroys or greatly diminishes opportunities for rent-seeking, it may lead to improved distribution over time.

In this respect, there is a great contrast between Latin America and Eastern Europe. These regions started the economic liberalization process from opposite ends of the spectrum of income distribution. The formerly communist countries of Eastern Europe had relatively even income distribution, and their liberalization policies of recent years, including economic openness, will almost certainly be accompanied by an increasing degree of income inequality. This may be the necessary outcome of stronger incentives for individual effort and entrepreneurship. For Latin America, starting from extremely high inequality, the impact of liberalization and openness is not clear.

* For a fuller discussion of this issue, see Inter-American Development Bank, Latin America after a Decade of Reform: Economic and Social Progress Report, 1997 (Washington, D.C.: 1997), p. 74.

Privatization has eliminated the assumption of lifelong tenure for the many employees of the previously public enterprises. The fiscal retrenchment required by macro-stabilization programs has generally resulted in a decline in subsidies and in some public services. Increasing integration into global capital markets has exposed economies to macroeconomic volatility, as evidenced most dramatically in the Mexican peso crisis of 1994—95 and its "Tequila effect" throughout the region. People also feel insecure because of the inability to obtain adequate education for their children, increasing crime in many parts of Latin America, and, in some cases, the rising prices of essential goods and services previously subsidized by government. Perhaps most responsible for this insecurity is the fear of unemployment. According to a 1997 survey by Latinobarometro,[3] 19 out of 100 Latin Americans think that the biggest problem today is unemployment, and 7 out of 10 rate themselves as concerned or very concerned about losing their jobs in the next twelve months.

Economic insecurity and volatility threaten to undermine political support for the prevailing market-oriented economic policies in Latin America. They cloud hope for the future, which is essential if people must cope with the disruptions of economic reform and the on-going changes inherent in a market economy. What must be done to alleviate these concerns? First, any return to high and volatile inflation would severely aggravate current insecurities. This means that the recent gains in fiscal and monetary discipline—which have been at the core of reform in many countries in the region and provide a foundation for long-term growth—must be preserved. But a second conclusion is that "more of the same," i.e., further advances in the "first stage" reforms of trade liberalization, privatization, and fiscal retrenchment, will not secure the progress to date toward market-oriented reforms. For countries that have already moved forward significantly in these areas, the near-term political priority should not be further steps in these same directions. These might only aggravate actual and perceived insecurity and thereby bring about political backlash. Instead, the next stage of reforms must be designed to reduce the prevailing insecurities and to decrease potential volatility.

It should be recognized that, in some countries in the region, much remains to be done to complete the agenda of "first stage" reforms.[4] For example, the privatization of inefficient public enterprises and banks has barely started in Brazil; the recent privatization of Telebras is an important step forward. In many countries, the consolidation of good tax regimes and administration that must underpin long-term fiscal management remains incomplete. In these countries, further progress in the early reform agenda must be undertaken in parallel with a next generation of reforms designed to mitigate insecurity and volatility.

Reducing economic insecurity will require better policies and programs to increase social protection and to improve key social services. These include: unemployment insurance, expanded health care coverage, better police protection and other measures to reduce general crime, broader and more secure pension systems, and education to provide skills for competing in the increasingly global marketplace. Progress in these areas—which few of the countries of Latin America have achieved—would not only contribute directly to the quality of life but would also secure continued political support for the market-oriented reforms already in place. Arguably, progress in social protection is necessary so that a society can endure the vagaries associated with a market-driven economy (see box 2). In this sense, defense of existing market-oriented policies may require, as a priority, a good offense in these areas of social protection and services.

BOX 2. SOCIAL PROTECTION AND ECONOMIC OPENNESS

Cross-country data indicate a strong and positive correlation between the share of GDP spent on social protection and the openness of an economy to international trade. But how should this correlation be interpreted? It is argued by some that expenditures on social protection increase in order to offset the insecurity and volatility associated with open economies.* From this perspective, social protection is a necessary public good for capitalist societies. The implication for Latin America is that, as economies are increasingly integrated with the world economy and subject to more rapid economic change through their active participation in global markets, they must necessarily increase expenditures on social protection in order to offset the negative aspects of such participation.

But it may be that the observed correlation between the levels of social protection and openness reflects a very different process. Openness means more rapid growth and higher per capita income; and, as countries become wealthier, they may be willing to allocate a higher share of total income to social protection programs. From this point of view, social protection is more like a luxury good, not an essential commodity of open economies. A variation of this interpretation might be that public expenditures on social protection programs always involve costly and inefficient bureaucracies and that a society's tolerance for such inefficiency increases as its income level rises.

* On this point see Dani Rodrik in "Sense and Nonsense in the Globalization Debate," Foreign Policy (Summer 1997).

The second broad focus for the next stage of reform should be policies designed to reduce macroeconomic volatility, which results in part from fuller participation in the global economy, including global capital markets.[5] The Mexico crisis in 1994—95 and the Asian crisis in 1997—98 show that even the most successful emerging markets are vulnerable to volatility, which may be triggered—or simply aggravated—by huge movements on the international capital markets. Although the volatility associated with capital market movements is to some extent likely to be an inevitable part of participation in the global economy, there is much that national governments can do to reduce the probability and magnitude of recessions caused by this volatility. The required measures include better fiscal management and much healthier, more resilient banking systems.[6]

Within the broad range of policies that would reduce macroeconomic volatility and economic insecurity, strengthening domestic banking systems and advancing education reform are critically important in most countries of the region. The rest of this paper will consider in detail these two key goals. These two challenges are not necessarily the most important pending reforms in every country of the region. For many countries, reforms in labor market regulation and practice, for example, may be even more important and urgent.[7] Labor market reforms are essential both for accelerating efficient growth in an open economy and for ensuring some level of social protection (e.g., unemployment insurance) to offset the negative consequences of such openness. Civil service reforms are also critical in most countries[8] (see box 3). But strengthening banking systems and improving education are certainly important goals throughout the region. They have been chosen for close examination in part because they represent reforms at different ends of a spectrum. Strengthening banking systems is a "state-centered problem" that involves the direct engagement of a relatively small set of political and economic elites. In a sense, the necessary reforms can be pressed successfully in a top-down manner. Advancing education reform, in contrast, is a "society-centered problem" that involves broad participation not only from political elites but also from communities and parents at all levels of society. It can only be achieved through successful work at a grassroots level and through much bottom-up effort.

BOX 3. THE CENTRAL IMPORTANCE OF CIVIL SERVICE REFORM

The "second stage" of reforms discussed here—increased social protection and services and policies to reduce macroeconomic volatility—require a competent state. Providing higher quality public education, regulating private pension funds, supervising banks, and managing fiscal resources in a counter-cyclical way all require a level of institutional capacity that now eludes most Latin American governments. Achieving broad progress in these areas will therefore require some type of civil service reform. The creation of a new class of professional, non-corrupt civil servants would have a tremendous impact on the evolution of political and economic debate in the region. It would transform the present, often sterile debate about the appropriate size of the state and turn it toward issues of how the state can complement and improve a market-driven economy.