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GROWTH, INEQUALITY, AND SOCIAL EQUITY IN ARGENTINA

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Background

The dramatic economic collapse in Argentina, culminating in 2002, resulted in the deepest political and economic crisis in generations. Few countries have experienced such economically catastrophic events. Over the four-year period from 1999 to 2002, gross domestic product (GDP) fell by over 20 percent. The human costs of the precipitous decline in economic activity have been substantial. The urban poverty rate shot up to 57.5 percent in October 2002, while income inequality, which had been rising steadily, peaked in the aftermath of the crisis. By 2003, Argentina's economy began to rebound strongly. Sparked initially by increased exports and by a gradual expansion of consumption spending, a demand-led recovery emerged. This recovery has had a positive impact on the living standards of the population. Nevertheless, the economic and social advances were relative to their very low starting point, and large segments of the Argentine population continue to face great hardship.

Sustaining the current positive economic trend and ensuring that it will benefit the poorest is a matter of top priority for the Argentinean government. In fact, one of the difficult tasks that the country faces today is to implement policies needed to support the economic recovery, assist employment creation, and enhance the living conditions of the population. A recent report

prepared by the World Bank reviews Argentina's growth, poverty and income inequality performance¹. Valuable policy lessons can be drawn from the study. This note presents some of its key findings.



Russell Gordon

Growth, Poverty and Inequality Performance in Argentina

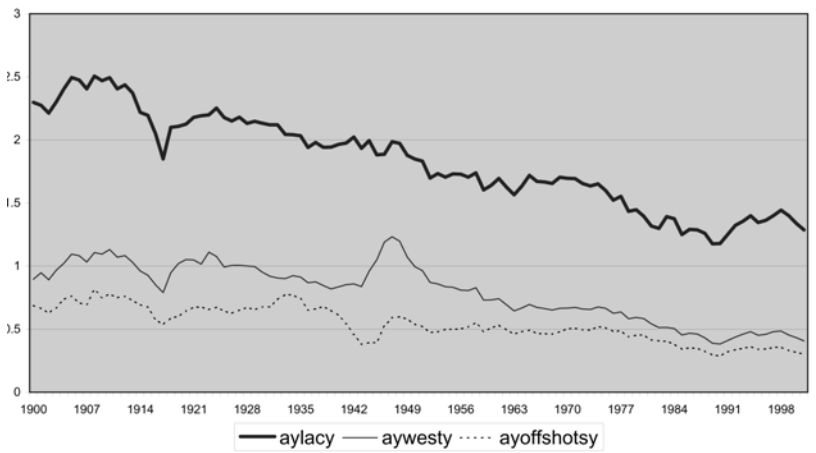
The country's slow economic growth over the past ninety years has been extensively discussed by economic historians. Argentina was among the world's highest income countries in 1913. Historical data shows that economic growth was clearly disrupted in most countries due to the adverse shocks of the Great War, the interwar economic strains, the Great Depression and World War II. Yet other countries with comparable living standards and growth records before

these events subsequently managed to continue their growth trend. This was not the case for Argentina, where growth did not resume anywhere near previously observed rates, and the economic slowdown set in beginning around the time of World War I.

Between 1950-2000, Argentina's per capita income diverged downward vis-à-vis the industrialized countries, while its per capita income converged downwards towards Latin America's (See Figure 1). Even among Latin American countries, Argentina stood out as a particularly slow growth country, and only in Venezuela and Bolivia were growth rates lower. As a result, Argentina, once an unquestionably advanced nation, became relatively poor. This is one of the great puzzles of the country's economic history. Unfortunately, there are no totally convincing simple answers to the question of what accounted for the languishing performance of Argentine growth.

The last several decades revealed another puzzle. Inequality has increased persistently, resulting in rising levels of poverty in the face of stagnant, albeit widely fluctuating, average per capita output. Per capita GDP in 2004 was at about the same level as in 1974. Nevertheless, poverty was much higher in 2004, reflecting an increasingly unequal distribution of income. Remarkably, the rise in inequality, and poverty, was observed in periods of both growth and recession (See Figure 2). Moreover, although Latin America has not been very successful in reducing poverty and inequality, the recent record of most countries in the region was better than that of Argentina. As a result, Argentina today is not the low poverty, and more equitable country (by Latin

Figure 1: Ratio of Argentina's Per Capita GDP to Per Capita GDP*, 1900-2001



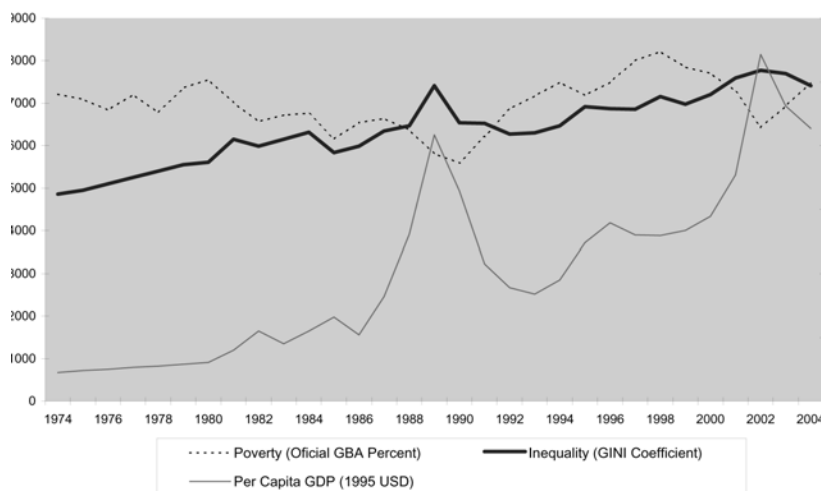
*Average of 12 Western European countries (aywesty), of 4 Western Offshoots (ayoffshotsy), and of Latin American countries (aylacy). Western Offshoots include USA, Canada, Australia and New Zealand. Source: World Bank staff.

American standards) that it was in the early 1990s. Not only has growth been slow in Argentina, but there also has been substantial volatility in economic performance. Business cycles are common in all economies, but the Argentine case seems to be set apart. Its erratic economy may have contributed to slower growth over time as suggested by recent empirical studies. In fact, Argentina possessed greater output volatility between 1960-99 than any other Latin American country or any major region, reaching its peak during the chaotic decade of the 1980s. With greater stabilization and macroeconomic balance in the 1990s, Argentina's volatility was reduced, but it still remained higher than in most other countries.

Causes of Slow Growth and Poverty Increases

Why has economic growth been so low in the country? One perspective explains it by a lack of productivity growth. Productivity growth has long been recognized as a driving force for sustained economic growth. In the case of Argentina, a large number of recent growth accounting studies have sought to measure total factor productivity (TFP) growth since the 1940s. There is a certain commonality in the results of these analyses. First, average TFP growth is generally seen to be low, hardly more than 0.5 percent per year. Second, TFP growth rates are quite erratic, reflecting Argentina's high volatility as noted above. Third, the average TFP growth estimates are typically negative for the chaotic 1980s, and most positive for the 1990s. Fourth, when attempts are made to incorporate human capital accumulation, the estimates of TFP growth decrease appreciably.

Figure 2: Per Capita Income, Poverty & Inequality in Argentina, 1974-2004



Source: World Bank (2005)

The “informal empiricism” of economic historians highlights other key developments to be considered in understanding Argentina’s poor growth performance - the closing of the economy in the 1930s, the reduced access to international capital markets that followed, inadequate investment incentives throughout much of the post-war period, macroeconomic instability, the increased burden of the state after the 1930s, and weaker property rights. The negative impact of these developments was validated by international experience and recent cross-country econometric studies. Overall, improving macroeconomic stability, facilitating private sector investment, strengthening the legal and institutional framework, having a well-functioning system for financial mediation, promoting trade expansion and greater openness of goods markets, and extending human capital formation appear to be crucial actions for achieving sustained high rates of economic growth in Argentina.

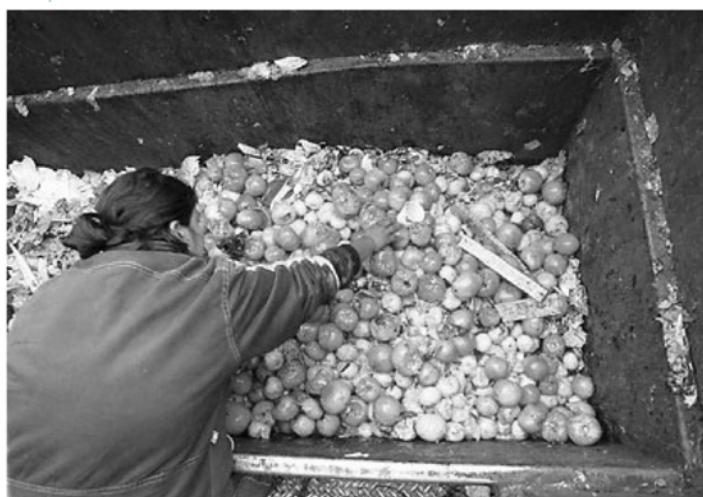
The country also has experienced rising poverty over time. However, the most striking fact is that poverty increased even in periods of economic expansion. The fact that poverty sometimes rose when growth was taking place is exceptional in international experience. As suggested before, low growth does not tell the whole story; increased poverty also was linked to a more unequal distribution of income. The question then arises as to why income became more unequal. Recent research has uncovered a number of factors that explain the change in income inequality. Key factors include: (i) an increase in the relative returns to higher education; (ii) a rise in the returns to unobservable factors, such as the quality of education, family background, individual ability and labor market connections, and the relative decline in hours of work for unskilled workers; (iii) an increase in unemployment during the 1990s and changes in labor force participation from 1996 onwards; and (iv) increased integration into the global economy that encouraged production and employment in the sectors using natural resources, helped reduce the relative price of capital, and introduced new “skilled labor” intensive technologies.

The high degree of income inequality is a factor that could have impaired growth. There is substantial theoretical and empirical literature that identifies channels through which income inequality negatively affects economic growth. As stated in one such study, “There is no evidence in the data that increases in inequality are good for growth. In fact, the bulk of the evidence goes in the opposite direction.”² However, further tests are needed before an unquestionable conclusion can be reached. Given the rising trend in inequality in Argentina,

it would be worthwhile to further explore this issue in future research.

Recent Crisis and Recovery

As indicated before, Argentina’s volatility stands out when compared to other countries. According to empirical studies, high volatility in macroeconomic performance usually contributes to increases in the level of inequality and poverty. A review of the last economic cycle in Argentina offers an eloquent glimpse on the link of volatility to poverty. After three years of continuing recession, the economic and financial situation of the country worsened during 2001. Various attempts to spur growth and improve public finances failed, and a crisis



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unfold. The social situation in the country, which was not good, significantly deteriorated after GDP declined by 10.8 percent in 2002.

Poverty and extreme poverty rates rapidly increased during the crisis. The official poverty rate showed that some 53 percent of the population was poor in May 2002, up from nearly 36 percent a year earlier. Additionally, the indigence rate rose from 11.6 percent to 24.8 percent during the same period. The economy rebounded quite strongly in 2003. Nevertheless, during the early stages of the recovery, poverty and indigence rates continued to increase, albeit only slightly.³ The economy continued to show strong performance by 2004, growing 9 percent. Importantly, economic recovery finally began to have a positive impact on living standards during that year, with poverty and indigence rates finally falling.

As expected, economic activity during the cycle was closely, and inversely, linked to income changes of the poor. Even when adjusted by government transfers, the income of the poor showed a positive correlation with the growth rate of the economy. Moreover, data indi-

cated that the poor benefited relatively more from the recent recovery - incomes of the poor grew faster than the average income of the entire population during the upturn. That is, the recent phase of economic recovery in Argentina has been a pro-poor growth process, not only in the absolute sense, but also in relative terms.

Why has recent growth been pro-poor? One possible explanation is that, as a result of changes in relative input prices, changes in sector growth patterns have helped increase the positive effects of growth on the poor. The reason is that changes in relative input prices probably led to changing patterns of inputs, and consequently shifts in the contributions of each economic sector to growth in aggregate production. A brief



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comparison illustrates the point. During the 1990s, interest rates decreased relative to wages, and the most dynamic sectors tended to be capital-intensive. In contrast, real currency depreciation after the crisis substantially reduced the cost of labor in the country. As a consequence, labor-intensive sectors became more competitive after the currency depreciation.

An overall review of the sectoral growth pattern during the recent recovery period reveals that:

- sectors that contributed most to aggregate GDP growth were different from those that explained growth in the 1990s. The recovery shows the relatively higher importance of the contribution of the goods-producing sectors, mainly manufacturing, while in the 1990s, the services sectors were most important;
- the dynamic sectors during the recovery have been relatively more labor-absorbing;
- the most dynamic sectors during the recovery demanded relatively more low-skilled workers compared to the sectors that led growth in the 1990s.

Since labor income is more important among the poor as a share of total income, and since the poor tend to be less-skilled, it follows that the pro-poor growth pattern observed during the recovery may have been linked to the sectoral composition of the recovery. In fact, those labor-absorbing sectors that grew the most during the recovery also accounted for most of the changes in poverty during the period. That is, the higher the economic growth of the sector (weighted by employment share of the sector), the higher was its contribution to poverty reduction.

Conclusions

The Argentine government has adopted a strategy that emphasizes rebuilding the economy with a view to delivering sustained growth with social inclusion - an appropriate goal in view of the high degree of poverty and inequality in the country. It is important to recognize that growth is not only essential, but that it is needed over sufficiently long periods and with sufficiently pro-poor impact so that all segments of the population can expect a notable improvement in their lives and their livelihoods.

The first part of the recovery after the deep crisis in 2001 has been successful in delivering strong growth with positive effects on the living standards of the population, especially the poor. Nevertheless, the persistence of sound macroeconomic policies in the future, as well as the implementation of other key policies, will be crucial to observe high growth rates and further reductions in poverty and inequality.

Notes

¹ See Report No. 32553-AR “Argentina: Seeking Sustained Growth and Social Equity.” The study also discusses selected key policies that could help improve growth rates, while decreasing poverty and income inequality.

² See Banerjee, A., and E. Duflo (2003). “Inequality and Growth: What Can the Data Say?” *Journal of Economic Growth*, 8: 267-299.

³ For example, the percentage of poor individuals increased from 53.0 percent to 54.7 percent between May 2002 and May 2003. Note that poverty rates peaked in October 2002, reaching 57.5 percent of individuals.

About the Authors

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