



## Globalism and Localism

### What are the limits of competition and security?

By Norman Gall and Rubens Ricupero

---

*Braudel Papers - N° 16, 1997*

The world economy has been growing into a wider web for centuries. But never before has globalization impacted local economies so fast and on so large a scale and never before has it bred such controversy.

While there have been many precursors and beginnings, the globalization process burst clearly into history in the 15th and 16th Centuries with the expansion of European mercantilist capitalism after the great voyages of discovery.

Globalization is the economic process of tying together our lives. At the core of the debate over globalization is the threat of competition, which often evokes unpleasant feelings. Competition may be the most disturbing force in globalization and the source of anxiety about the future that spreads among many countries. The root of the Greek word “agony” describes both the phase preceding death as well as stadium sports; agonistes in Greek means a contestant. In economics as in stadium sports, competition yields winners and losers. Why does competition bear social value? Through anguish and pressure, competition forces men to do their best and leads to innovation, invention and reduction of costs. Competition intensifies in a globalized world in which national markets tend, at least in theory, to form a single market. In its most efficient form, competition is not for all markets, only for free markets.

Is globalization creating more or less wealth and welfare, and for whom? Are sidelined countries condemned to the Outer Darkness of autarchic and retrograde stagnation? Will globalism and localism clash at the edges of the emerging world system? Or is globalization threatened more by tensions among the richer core countries, as happened before the First World War? Barring such a conflagration, the answers to these questions ultimately will be decided by the locals. The conflict between globalism and localism is defined anew on each territory, usually opposing global strategies of efficiency with local ideas of security. There are limits to both security and competition. Both embody legitimate interests. The important thing is to have the courage and self-confidence to decide a course of action, to avoid lingering ambivalence that leads nowhere.

Fernand Braudel called the long-term globalization process “the highest plane of the economy” that, in the 16th Century, “bestrode the political and cultural frontiers which each in its own way quartered and differentiated the Mediterranean world.” In those times globalization mainly meant long-distance trade, slow-moving by today’s standards, in precious metals, grain and high-priced consumer goods, as well as an evolving international payments system based on bills of exchange between bankers and merchants at distant points of the system. Braudel defined a world economy as “a sum of individualized areas, economic and non-economic, [extending] beyond the boundaries of other great historical divisions ....The world economy is the greatest possible vibrating surface, one which not only accepts the conjuncture but, at a certain depth or level, manufactures it. It is the world economy at all events which creates the uniformity of prices over a huge area, as an arterial system distributes blood throughout a living organism. It is a structure in itself.”

Angus Maddison, a leading analyst of world economic growth and a member of our Institute, observes that “integration of different parts of the world has grown dramatically since 1820 and the increased openness has had an important impact on growth potential,” with exports as a share of world output growing from 1% in 1820 to 17% in 1995. Despite distortions and injustices, institutionalized in decades of chronic inflation, Brazil benefited from this integration, leading all major economies in growth since 1870, multiplying its output 108 times. In the now-distant years of the “miracle” (1968-74), when their economy grew by 10% yearly, many Brazilians came to feel that fast economic growth was as naturally part of their culture as football, samba and the beach. However, times are different now and the tests are harder, because they test the quality of human institutions. From a strictly economic point of view, globalization is the product of three great movements. The first is the growth of world trade over the past three decades at rates faster than the growth of production, indicating more interdependence. The share of foreign trade in the U.S. economy rose from 4.7% of gross domestic product (GDP) in 1960 to 11.4% in 1994. China’s trade grew from negligible amounts in 1978 to 25% of GDP in 1994. While Brazil’s share of world exports was declining, shipments from other newly industrializing countries grew fast, from 0.2% of advanced economies’ GDP in 1970 to 1.6% in 1990, a small share of the importers’ total output that has bred intense political controversy. According to Paul Krugman of Stanford University, the reasons for this export growth “are deep and deeply disputed questions.” A new phenomenon, he explains, is slicing up the value chain, dividing manufacturing into geographically separate steps, joined thanks to technological leaps in transport and communications, with unfinished goods often exported for final assembly in intra-company trade.

While freer trade is a vital sign of globalization, it is not synonymous with the broader long-term process. Growth of trade accelerated after the conclusion in 1993 of the Uruguay Round of negotiations with a general lowering of barriers, tending to create a single market the size of our planet. Tariffs on industrial goods imported by the rich countries are now less than 10% of those in 1947, before the first of the eight GATT rounds of multilateral negotiations took place. Old quantitative restrictions are disappearing faster than new ones are invented as sanitary, technical and labor criteria blocking imports. Celso Lafer, former Brazilian Foreign Minister and now Ambassador to the World Trade Organization (WTO), observes that the trade opening “created new freedom for the government in fighting inflation and promoting economic modernization, but Brazil’s commitments within the WTO reduced its use of mechanisms of commercial defense and practically banned the instruments of trade and industrial policy that formed the core of the import-substitution model to which we were accustomed: quota restrictions, import licences, administrative measures invoking balance of payments problems, national content regulations and sectoral subsidies to stimulate exports.” These practical issues still must be tested in many countries by politics and markets. Extreme advocacy of globalization and free trade breed Utopian ideas that create confusion. Charles R. Carlisle, former Deputy Director General of GATT (General Agreement on Tariffs and Trade), warns against excessive optimism:

*The Uruguay Round was not about free trade, but freer trade, yet it almost failed....Although there has been a major movement around the world in the last decade toward freer markets and less regulation of economic activity, the developing nations, grappling with social and economic problems that dwarf those in the West, are not about to accept completely free trade. No country in the world embraces the belief in free markets and free trade to the degree that the United States, Britain and the other English-speaking democracies do. Many would see global free trade as contrary to their traditions, doctrines and interests.*

The second element of globalization is the enormous growth of investments, much faster than trade, especially over the past decade, mainly by transnational companies, becoming active in very diverse settings, thanks to improvements in transportation and communications, making notions of purely national production systems obsolete. Since the mid-1980s, annual flows of foreign direct investment (FDI) multiplied four-fold, from \$77 billion to \$318 billion in 1995. Geographic location of production is ruled now by the logic

of cost, the decisive factor of globalization. Today a simple golf club is made of four parts produced in four different countries. We only can imagine the national origins of parts for a car or a computer. This is a new idea that abandons the fetishes of national content quotas for manufactured products, embraced so fervently in Brazil's recent past.

The third element of globalization, growing much faster than investment and trade, is the surge of international financial transactions, which in 1992 dwarfed daily economic activity that averaged \$62 billion in production and \$10 billion in exports. According to the Bank for International Settlements, turnover in financial derivatives alone tripled from \$123 trillion in 1990 to \$328 trillion in 1995. The New York Clearing House's CHIPS electronic payments system, owned by 10 private banks, handled \$1.3 trillion daily in international transactions among banks in 1996, against only \$300 million daily in 1977 and \$1.6 billion in 1983. The Bank of England's CHAPS system cleared another \$400 billion daily and another \$500 billion was settled independently between individual banks. In 1994 the global market for investment-grade bonds was \$14 trillion, or nearly half of world GDP. Since the 1991-92 recession, net international financing has tripled, as have capital flows to Brazil.

While these statistics may impress us, we should not lose our historical perspective. What is happening today is not without precedent, nor does globalization extend to all factors of production. Between 1870 and 1914, there may have been broader globalization in the creation of what we see today as the modern world economy. Nevertheless, there were important exceptions. The two rising industrial powers of those decades, the United States and Germany, were protected by high tariffs while playing key roles in the globalization process. Today's globalization is a resumption of the integrating trend interrupted by the three decades (1914-45) embracing the two World Wars and the Great Depression, when protectionism and autarchy spread among rich and poor economies alike.

Globalization forms a dynamic hierarchy of unequal access and exchange among factors of production. Crowning this hierarchy are advances in communication—symbolized by personal computers, modems, CNN and the Internet—spreading powerful flows of information that even the most averse autarchies find hard to control. Instant information exchanges tie together world financial markets as never before, internationalizing flows of savings that ease fiscal pressures but make it harder for governments to conduct independent monetary policies. Growth of air transport, especially since wide-body jets started flying in 1967, favors trade in perishable cargoes such as cut flowers and fresh fruits as well as fast and far-reaching travel by salesmen and academics, and by Presidents and Popes, who now can visit several countries on different continents in the same week. Over 40% of U.S. overseas exports and 30% of imports now go by air. Cargo ships in 1950 were between 5,000 and 10,000 tons, compared with today's specialized ships of 150,000 tons and more, like supertankers, container ships and bulk carriers and roll-on-roll-off vessels, greatly reducing costs of shipping and port-handling, especially for low-value loads. Better communications and travel capacity, along with mobility of capital, eases international coordination of production and marketing. Cheap overseas telephone calls, fax machines and electronic mail facilitate close supervision of far-flung production sites and quick response to changes in design and demand. Thus the surge in direct investment in the 1990s. Total FDI inflows have doubled worldwide since 1991-92. It is striking that, while trade in services is more restricted than trade in goods, the fact that services is the largest sector of the world economy has enabled it to generate half of all FDI stock and nearly two-thirds of FDI flows.

Globalization is not a grand design. It has spread over the past generation, without much planning or foresight, thanks to spontaneous demonstrations of the vitality of capitalism and democracy while statist systems relapsed into disorganization and poverty. It has shown, again and again, a correlation between increases in trade and foreign investment and economic growth. The past two decades proved once more the stability of the peacetime world economy with its return to long-term growth trends. Looking backward over the past 135 years, the only big output losses for the world economy came from war. The Great Depression was provoked by the artificial asset inflation and financial imbalances bred by World War I. "The aggregate stability in the collective output in peacetime has been quite impressive," observed Maddison. In the 43 years from 1870 to 1913, there were only two

years [1893 & 1908] of output loss for the world economy as a whole, and since 1947 only two more years [1975 & 1982]. Many economists complain that real world output in the 1980s and 1990s has been growing by “only” 3% yearly, far slower than the 4.9% growth in the postwar “Golden Age” of expansion (1950-73). These critics fail to consider that this “Golden Age” was an exceptional period in economic history. Growth was driven by rebuilding wartime damage, meeting a backlog of consumer demand, rapid urbanization and suburbanization, big increases in government spending, the prolific spread of new inventions and the expansion of international business. By now war damage has been repaired and new infrastructure built. Pent-up demand for consumer durables for the middle classes has been met while urbanization reached saturation levels in many rich and poor countries and public spending grows more slowly.

### **Globalization Is Not Global**

Despite the slowdown, inventions continue to spread and international business continues to expand, tying together the world economy as never before. Though growth of world GDP has fallen below the spectacular pace of the “Golden Age,” present rates still are above long-term trends for both rich countries and the world economy as a whole. Expansion of world trade volumes and of developing economies in the 1990s is approaching the tempo of the 1960s. For the first time, developing countries are generating one-fourth of world trade. Their trade is growing 3-4% faster than the world average and increasingly is among themselves, with the regional trade among the 10 biggest Asian economies now approaching the sum of their exchanges with Europe and the United States. Slowing of population increase in most of the world means that, except in Africa and Eastern Europe, per capita output continues to rise vigorously, even at lower rates of overall economic growth than in the first postwar decades. Per capita incomes keep growing in Western Europe (at 1.8% yearly in 1973-92) despite the cost burdens imposed by the Welfare State, enlarging public debt and diverting savings from investment into consumption. Nobody knows how long these burdens can be sustained. They are emerging as a focus of conflict between globalism and localism in both rich and poor countries.

In addressing these uncertainties, we must remember that globalization is far from global. The bulk of trade and foreign investment are concentrated in a few countries. UNCTAD's World Investment Report 1996 shows that the 11 biggest host countries (10 OECD members plus China) received two-thirds of all FDI inflows and generated 78% of all outflows in 1995, while the 100 least-favored countries received less than 1%. The trend is toward more concentration. Nearly 90% of the increase in FDI inflows in 1995 went to developed countries, with their share rising from 59% in 1994 to 65% in 1995, far exceeding their portion of world output.

“What is new is the more complex form that efficiency-oriented strategies are taking, the extent to which value-added activities are fragmented and dispersed and the growing scale on which this is happening,” UNCTAD observes. “In complex integration strategies, any value-added activity can be located, at least in principle, in any part of a TNC system, and integrated with other activities performed elsewhere to produce goods for national, regional or global markets.” There is a real risk that countries failing to enter this network will be sidelined from the growth process, since two-thirds of world trade is run by TNCs.

The distribution of growth in direct investments in less-developed countries tends to follow the slicing of value added, showing that globalization is an expanding but skewed and selective process. Africa and Central and Eastern Europe each absorbed only 0.2% of Japan's fast-growing FDI stock by early 1996. In 1995 poorer countries received \$100 billion in FDI, a doubling in only three years. Of this record total, \$36 billion went to China and two-thirds to all of Asia. Investment fever in favored countries like Mexico and China shows how unstable these flows can be. FDI flows to Mexico nearly doubled in 1990-91, only to fall slightly over the next two years before nearly doubling again in 1994 after passage of the North American Free Trade Agreement (NAFTA). They shrank once more during Mexico's currency-debt trouble of 1994-95, but have revived again. Latin America partook weakly of these enlarged flows, its share of developing countries' FDI falling from 35% in 1992 to 27% in 1995. All of Africa received only \$4.7 billion in 1995, its share

falling by one fifth, about the same as Brazil's alone. Brazil's FDI inflows doubled in 1996 to \$10.5 billion, triple its share of poorer countries' exports. Similarly, Latin America received 8% of global FDI in 1995, more than twice its falling share of world exports. These trade and investment patterns show that the outside world views Latin America's potential more as a market than as a source of goods and services for other regions. If they fail to strengthen their export capacity, Brazil and the rest of Latin America are headed for chronic balance of payments troubles for the foreseeable future. According to JP Morgan, FDI "in [Brazil's] domestically-oriented sectors can actually hurt the financing picture over the medium term, in the event that it promotes dividend withdrawals without generating exports" to pay for them.

The bulk of FDI growth among developed countries is in mergers and acquisitions (M&As) and not in creation of new production capacity. In 1995, U.S. companies spent \$38 billion to buy majority stock in cross-border M&As, or 90% of the equity in FDI outflows from the United States, a spillover from the domestic merger fever of the 1980s, when \$2 trillion was spent to buy 55,000 U.S. companies. Small and medium-sized firms play an increasing role in M&As. However, only 6% of cross-border M&As involving purchase of majority ownership took place in the poorer countries. These flows tend to fluctuate wildly, depending recently on political decisions on privatization of state enterprises. Since 1988, three-fifths of the value of M&As in Brazil and Mexico came from purely domestic takeovers. In Brazil, however, foreign participation doubled in each of the past three years as privatization gained momentum. In 1994, before Mexico's currency crisis, Brazil and Mexico jointly absorbed 88% of the value of cross-border M&As in Latin America. Brazil is host to 10,000 affiliates of foreign companies while 800 of its own companies invest abroad. Investment decisions, especially in developed countries, are leading to tighter integration and consolidation of the world's industrial structure. According to UNCTAD's estimates, one-third of world trade is now intra-firm sales of trans-national companies (TNCs) and another third is trade between different TNCs. Only the remaining third is between strictly national firms, whose room for action is increasingly restricted. Generating 21% of world output and 13% of all exports, the United States is both the biggest national market and the hub of the globalization process, absorbing 19% of all FDI inflows and investing 30% of all outflows. By 1993, intra-company trade generated nearly half the imports of U.S. parent firms and 85% of imports by their foreign affiliates. Foreign and domestic sales of affiliates of TNCs equaled 6% of the world product in 1991 and 128% of exports. Like Coca-Cola in the first post-war generation, McDonald's is now a symbol and caricature of the globalization process, in 1995 making 47% of its sales and 54% of its profits from foreign outlets. Thomas L. Friedman of The New York Times described how McDonald's adapts to new markets:

*The way McDonald's has packaged itself is to be a "multi-local" company. That is, by insisting on a high degree of local ownership, and by tailoring its products just enough for local cultures, McDonald's has avoided the worst cultural backlash that some other U.S. companies have encountered. Not only do localities now feel a stake in McDonald's success, but more important, countries do. Poland for instance has emerged as one of the largest regional suppliers of meat, potatoes and bread for McDonald's in Central Europe. That is real power. Because McDonald's is gradually moving from local sourcing of its raw materials to regional sourcing to global sourcing. One day soon, all McDonald's meat in Asia might come from Australia, all of its potatoes from China. Already, every sesame seed on every McDonald's bun in the world comes from Mexico. That's as good as a country discovering oil. This balance between local and global that McDonald's has found is worth reflecting upon. Because this phenomenon we call "globalization" —integration of markets, trade, finance, information and corporate ownership around the globe— is actually a very American phenomenon: it wears Mickey Mouse ears, eats Big Macs, drinks Coke, speaks on a Motorola phone and tracks its investments with Merrill Lynch using Windows 95. In other words, countries that plug into globalization are really plugging into a high degree of Americanization. People will only take so much of that. Therefore, to the extent that U.S.-origin companies are able to become multi-local, able to integrate around the globe economically without people feeling that they are being culturally assaulted, they will be*

*successful. To the extent that they don't, they will trigger a real backlash that will slam not only them but all symbols of U.S. power.*

Trade as a share of world output did not recover its 1913 level until the mid-1970s. In those decades before the Great Wars, apart from growing trade and capital mobility among many countries, there also was relatively free migration of workers. The 4.4 million immigrants to Brazil in 1821-1932 were more than its whole population in the early 19th Century. In the century before 1914, over 60 million Europeans emigrated, 32 million of whom went to the United States, whose booming economy operated behind high tariff walls. Today there are fewer barriers to trade but tighter legal restrictions on labor mobility among the rich countries, even though we live in one of the great ages of human migration, both legal and illegal.

McDonald's will not become McWorld, yet McDonald's is opening new restaurants in the poorer outskirts of São Paulo, where levels of consumption have improved since the Real Plan opened the economy and stopped escalating chronic inflation. Combining economic openness and fiscal austerity has benefited nations of Latin America until recently afflicted by chronic inflation, offering new freedom and stability while yielding impressive electoral dividends to democratic governments in Argentina, Bolivia, Brazil, Chile and Peru. Two Harvard economists, Jeffrey Sachs and Andrew Warner, argue that "one dominant global economic system is emerging....The years between 1970 and 1995, and especially the last decade, have witnessed the most remarkable institutional harmonization and economic integration among nations in world history." They add that the driving force of these changes is trade liberalization, which "not only establishes powerful direct linkages between the [national] economy and world system, but also effectively forces the government to take actions on other parts of the reform program under pressure of international competition." Economic opening spawns an awesome agenda of institutional reform. Among these reforms are freeing prices, restructuring taxes and budgets, privatization, creating judicial systems with enforceable legal codes and procedures, better government regulation and revising the social contract to reduce wasteful and costly privileges while caring for those most in need.

What are the dangers? The dangers are mainly institutional, threatening destructive conflict between globalism and localism. Like many western and former communist governments and peoples, Brazilians are embroiled in conflict over acquired rights that are generous on paper but cannot be sustained within the present framework of public finance. Over the next decade we can consolidate political and monetary stability only by meeting three institutional challenges. We must enhance the viability of fiscal federalism, financial markets and the social contract. We then will be able to conduct our politics in a framework of more realistic expectations and to recover our capacity for public investment. We must create and maintain more effective public institutions to improve our economic performance and the productivity of investment. Both public and private investment are needed urgently for us to participate more fully in the world economy. The degree to which we meet these needs is a matter for local decisions based on our own interests and not on the priorities of foreign governments, international agencies and global corporations. All societies, even western ones, do not equally value competition. Brazil will decide how much competition it will tolerate. Neither security nor free competition are absolute values, but exist in degrees according to viability and priorities determined locally by economic potential and political decision. The responsibility for success or failure lies with ourselves. We now explore related issues of public finance, privatization of infrastructure and the social contract to understand better the choices that lie ahead.

The expanding web of economic activity not only offers nations and communities a choice of whether or not to participate, but also demands of them a fusion of the ways they handle their domestic finances. The most dramatic result of this fusion is the worldwide fall in inflation rates since 1990, by half in the advanced countries and by two-thirds in the rest of the world. The curbing of inflation opened the way for convergence of interest rates in the biggest economies and access to international capital markets for countries excluded until recently. But many countries, not only Brazil, now are grappling with growing public debts

and deficits, which could be a prelude to renewed inflation. One of the most spectacular results of financial liberalization and deregulation, intensified capital flows, enables countries to use short-term foreign borrowing to postpone difficult political decisions. The globalization of the world economy may be stalled by the globalization of public debt. Brazil's fiscal problems, and its avoidance of choice, are moving along the same path as those of many rich countries, posing the clearest threat to the economic and trade expansion, fed by cheap money, that is driving global integration. Among advanced countries, average levels of gross public debt surged from 40% of GDP in 1980 to 70% in 1995. Brazil's gross public debts (foreign and domestic) rose from 25% to 50% of GDP, and are harder to service because of its past history of chronic inflation and defaults. As in the rich countries, Brazil has raised tax revenues dramatically over the past two decades, from 23% to 31% of GDP, but still cannot contain growth of public spending. An international consensus is building among specialists that any reduction of public debt will have to come from spending cuts. Sailing until now on a crest of expanding world liquidity, Brazil has been able to use foreign financing, much of it short-term, to support its effort to stop chronic inflation while avoiding institutional changes needed to keep prices stable. Historical experience, especially with sudden changes in perceived risk and international interest rates in 1928-29, 1981-82 and 1994-95, shows how dangerous dependence on short-term foreign financing can be. The danger increases if government borrowing in the rich countries continues to grow, driving up international interest rates.

Brazil faces tough choices with regard to fiscal federalism and state capitalism. To stabilize public debts at their present level, according to one estimate, Brazil's federal, state and local governments together would have to improve their accounts by 3% of GDP, reflecting a shift from spending 1.4% more than their receipts into a 9% surplus. The burden of this shift toward fiscal balance to stabilize present debt levels would be borne by state and local governments, which would have to move from spending 8% more than their income to generating an 8% surplus just to meet current obligations. While federal banks are carrying out massive refinancing of state debts, which in early 1995 were estimated by the World Bank at \$140 billion, there is little chance that rollovers alone will solve the problem without major changes in the fiscal structure.

Under Brazil's 1988 Constitution, federal transfers to states and municipalities rose enormously. A tripling of municipalities' share of public spending led to creation of more than 1,000 new local governments to harvest the transfers. Virtually all this new money went to hire new state and local employees, most of them enjoying guarantees of job security under the new Constitution. The legislative and judicial branches of federal and state governments, guaranteed "autonomy" by the new Constitution, gave themselves generous salary increases and pensions, while teachers, accounting for one-third of all public employment, continued to earn the lowest pay as the quality of schooling fell. The federal payroll was cut deeply since military rule ended in 1985, but states and municipalities hired aggressively, with people with less than four years of schooling generating nearly half the increase. "The public administration clearly tended to pay its poorly qualified employees much better than the private sector and did the opposite with its best-trained people," a study by the government's economic research institute (IPEA) reported. While the number of public employees in Brazil is low compared with rich countries, it is high in many communities depending on government transfers, salaries and pensions for survival. This dependence shaped Brazilian political culture and gave it its extraordinary resilience. Over the past decade, it also spawned huge and growing public debts that threaten to bankrupt the government and to end economic stabilization. Brazil cannot operate in a more integrated world economy without ending these fiscal distortions. This is where the choice lies, where the conflict between globalism and localism is clearly engaged.

In some ways, Brazil's state capitalism spawned public finance problems akin to those of former communist countries. These are (1) circular defaults and chronic payments arrears among state enterprises and local governments, especially for wages and basic inputs such as electricity, fuel and telephone services; (2) huge volumes of non-performing loans from public banks, often to state governments and other public agencies, which in Brazil has led to some of the biggest bank failures in the annals of world finance; (3) non-payment of taxes and social security contributions. Both Brazil and the countries of Eastern Europe have

sequestered budgeted funds in their struggles for fiscal balance and have made dramatic progress in liberalizing prices and reducing subsidies, but still face political obstacles to advancing further. From these experiences, and from those of Argentina, Bolivia, Chile, Peru and Mexico, it becomes increasingly clear that the goals of economic stabilization and deeper participation in the world economy are neither separate nor separable in practice.

### **Globalization of Public Debt**

In many advanced countries, as in Brazil, net unfunded pension liabilities exceed the current national debt. Driving debt growth in the OECD countries was the surge of transfer payments (public pensions, subsidies and interest) from 8% of GDP in 1960 to 21% in 1992 caused by the transformation of targeted social safety nets into universal benefits. Voters and politicians still have not reduced their expectations about the level of benefits that governments can afford to provide for their citizens. In recent years, large flows of money have gone to wealthy retirees who need no financial aid. In the United States, an estimated \$64 billion in Social Security benefits go to households with annual incomes over \$50,000 while aid to the poorest households is being cut. West European governments have struggled with some success over the past decade to stop increases in social spending, which remain stuck at roughly one-fourth of GDP. In several countries, notably Austria, Belgium, France, Germany, Greece, Italy, Netherlands and Spain, social security contributions by employees and employers are over 40% of gross earnings. "Perhaps the most important adverse effect of high social charges is that they drive a wedge between the formal and informal components of the labor market (particularly in low-paid jobs because of contribution ceilings)," observed the director-general of the International Labor Organization (ILO), "inducing labor to flow to those jobs and occupations where social charges can be most easily avoided, rather than those which are most productive and profitable."

Brazilian transfers take varied forms, heightening the sense of waste and injustice in public finance. They rose since 1980-85 from 12% to 18% of GDP as overall government spending increased from 24% to 27% of GDP. Public pensions in Brazil absorb 8% of GDP, against 10-15% in most European countries, a very high burden for such a young population. With 40% of the labor force informally employed, its pool of contributors is much smaller than the number of present and potential pensioners. Meanwhile, retirees are divided into two classes: the plebes and the nobles. The plebes are 87% of the pensioners, most of whom retire at age 60 with a monthly social security payment of roughly \$120, equal to the minimum wage. The nobles are the other 13%, absorbing one-third of all benefits as members of politically influential professions, who can retire under "special regimes" as early as ages 45 or 50, with monthly pensions that can run from \$7,000 to \$20,000 or more. Many politicians and public officials accumulate two or more pensions during their working career. A state attorney in São Paulo can retire in his 50s with a lifetime monthly pension of \$12,000-14,000, an income beyond the dreams of all but the wealthiest in the United States or Europe. Perverse incentives usher public servants into early retirement with pensions 20% higher than their final salary, which by custom is topped up with a promotion shortly before they leave. They then can be rehired by the same or another public agency to earn a new salary alongside their pension. The federal government now pays more to pensioners than to active employees. Falsified work histories and disability claims breed widespread fraud to obtain benefits. Evasion of social security payroll taxes is estimated at 40% of owed contributions, with many private firms and public agencies keeping salary deductions for themselves. In 1996 the federal treasury transferred \$760 million to social security in partial payment of \$1.2 billion owed by the federal railway system, roughly equal to the railroads' market value for privatization.

For Brazil, the survival of state capitalism is at issue in decisions over privatization and new infrastructure, which are the focus of a big global market. From 1984 to 1995, 86 countries privatized 547 infrastructure companies worth \$357 billion. Also, some 600 new private projects, worth \$308 billion or more, are underway in 82 countries. Half of all privatizations and 70% of the new projects are in developing countries.

Nevertheless, it is becoming clear that privatization has been oversold by many of its advocates as a panacea for problems of statism. Privatization breeds a new generation of



institutional problems, mainly connected with neglected regulation of public utilities and near-monopolies, that will frustrate efforts of some countries with weak public institutions to create viable standards of fairness and efficiency. The World Bank in 1994 reported: “Developing countries have virtually no experience with regulation of private providers because their infrastructure enterprises have, in the main, been publicly owned and operated.”

The political and technical complexities of new regulatory regimes force us, as in many other areas, to face the problem of education. Brazil’s adult population averages only 5.2 years of schooling, comparable with countries that are much poorer and far below the average of 13-15 years for adults Europe and 18 years in the United States. Only 10% of pupils entering the first grade complete a secondary education, with 53% repeating the first grade. In São Paulo, the world’s third-largest metropolitan area, 52% of all heads of households did not study beyond the fourth grade. While the poorest fifth of Brazilian adults have only 2.1 years of schooling, the dispersion of education among income groups is less shocking than the fact that the richest 20% of Brazilian adults have completed only 8.7 years of school. It is hard to operate a complex society with an elite invested with such little education. It is even harder to imagine such a poorly educated elite exercising politically independent regulatory authority over privatized public services, involving legal and technical complexities in calculations and decisions as well as in negotiations with some of the most sophisticated private operators in the world. Yet this is the challenge facing Brazilian authorities after the current wave of privatizations. The only way forward is over a long and costly curve of learning by doing. Globalization is an educational as well as a competitive process. Brazil and many other countries need this kind of exposure.

Recent technological innovations —like cellular telephones and low-cost gas-fired turbines enabling independent powers producers to gain access to national electricity grids— have opened new areas of competition in industries until recently run as “natural” monopolies, mostly private utilities in the United States and state corporations elsewhere. While regulatory reform was driven in large measure by technological change in the United States, privatization everywhere has been forced more by the need to contain public deficits, involving choices between the fiscal demands of state corporations and the transfer commitments of the Welfare State.

What may facilitate political solutions is the flexibility developed over the past two decades by privatization and regulatory reform. Partners in economic restructuring, the two processes differ in origins but can act together to accommodate politics and markets. Pioneered in Britain, where the government sold some 50 major businesses for nearly \$100 billion since 1979, privatization is marked by continuing experiment and improvisation. Governments seek to sell bulky but unprofitable “assets” on domestic financial markets, often trying to create “people’s capitalism” of small shareholders amid heated political controversy. In Russia and other ex-communist countries, privatization often has been a game played by political insiders and state enterprise managers to gain quick and cheap ownership of public assets. Experience in both Britain and Chile, leader of privatization in Latin America, shows that mass sell-offs demand development of new institutional investors, such as pension funds, that later may play a role in corporate governance. In France and Italy as in Brazil, huge public enterprises dominate electricity, telecommunications and banking. Europe is moving along a “stop and go” obstacle course of privatization that Brazil eventually may follow. In France, where many state corporations operate in high-tech sectors and are leaders in their markets, “stop and go” meant that 31 state banks and companies were sold for roughly \$10 billion in 1986-88 before a Socialist election victory led to a “public sector breather,” increasing the number of state enterprises from 2,000 to 2,600 and adding another 400,000 jobs. After the Right won the 1993 parliamentary election, eight more state companies were fully or partially privatized in the stock market, yielding another \$23 billion. Many countries try to exclude or limit foreign roles in privatizations, but the small size of domestic financial markets often forces them to woo foreign investors. In France the foreign share in privatizations rose from 2% in 1986-88 to 12% in the 1990s. In France and Italy as in Brazil, fiscal pressures for privatization are reinforced by secondary issues such as corruption, lack of accountability by management and poor performance of public enterprises. While Brazil’s federal and state banks make 55% of all loans, Italy’s public

institutions generate 80% of all bank credit. In both countries, and in France, government banks are ridden with bad loans and political scandal, most recently in the failures, the biggest in financial history, of Banespa (State Bank of São Paulo) and Crédit Lyonnais, the world's largest bank outside Japan. As in Brazil, most Italian public enterprises enjoyed soft budget constraints and are shielded from bankruptcy, while their obligations to stakeholders (the government and other owners and creditors) are unclear. Private investors are venturing into this murky and sheltered world with prospects that are not easy to foresee. "Solving the corporate governance problems inherent in public management of enterprises is an explicit goal of privatizations in all market economies," Andrea Goldstein and Giuseppe Nicoletti, two Italian economists, observe, "but tackling the issues that remain after transferring ownership from public to private hands has seldom been an overriding concern."

In Latin America, privatization has moved forward fast under fiscal pressure during economic stabilizations in Argentina, Bolivia, Chile and Peru, but has been treated with ambivalence by leaders of the biggest countries, Brazil and Mexico. Among poorer countries, Latin America has received half of all foreign privatization capital, as inflows swelled from \$183 million in 1989 to \$3.7 billion in 1994, but in 1994-95 got only one-tenth of new project finance. Much of today's privatization wave involves purchase by foreign investors of ownership and/or management of railroads, power stations, telephone companies, water and sewage systems and other infrastructure built by British, U.S., French and Canadian firms before shrinkage of investment and trade flows after 1929. On the eve of World War II, 35% of all U.S. direct investment stock in Latin America was in infrastructure and transport facilities, amounting to 22% all U.S. direct investment worldwide. These investments now are reviving in response to huge demand, often involving reprivatization of companies, like Brazil's electric utilities, that were nationalized in recent decades. The World Bank finds that, at current economic growth rates, East Asia will need \$1.4 trillion in infrastructure investment in the next decade, \$700 billion in China alone. In Latin America, \$600-\$800 billion more will be needed. At Latin America's current low savings rates, these investments cannot be funded locally. This is a buyers' market because international engineering and construction companies are hungry for business due to the dearth of new projects in the rich countries. Public investment in infrastructure in the United States fell from 3.1% of GDP in the 1960s to 1.4% in the 1980s. The real choice is either to make deals with foreign investors, who built Latin America's first generation of modern infrastructure, or to allow more deterioration and obsolescence of the systems already in place. There are signs that the choice already has been made.

The world's biggest new power projects are concentrated in developing countries. Big projects are underway in Indonesia, India, Pakistan, Philippines, Colombia, Hong Kong, China, Turkey and Malaysia. "Limited recourse" financing of a "special purpose corporation" imposes severe discipline and shared risks on all parties, improving repayment and enabling sponsors to raise large amounts of credit on small amounts of equity. Banks rely solely on the project's cash flow for debt service, for which revenues must remain at least 40% above loan repayments. Sponsors' liability is limited to their equity in the project, usually about 30% of total cost. Performance bonds and guarantees heavily penalize contractors and suppliers who fail to meet deadlines as well as wholesale consumers, often state corporations, that renege on "take or pay" purchase contracts. Great care is taken to avoid the kind of tug-of-wars with foreign investors over tariffs that ended in nationalization of utilities in Brazil and elsewhere in Latin America. Complex and painfully-negotiated contracts provide for international arbitration of disputes and protection against loss caused by changes in user charges, laws, taxes, government intervention and currency devaluation. According to the World Bank, a standard agreement yielding 20% return on equity and 10% annual interest could lock in total outflows equal to two to four times the original investment over a 10-20 year payout period, generating hard-currency demands for user charges that can be politically unsustainable. No wonder that these deals are negotiated at such expense and difficulty, often in a climate of fear and mistrust, and that only 20% of private projects in poorer countries survive the development stage to go on line. The key words here are hope and desperation.

Despite the difficulties, both new infrastructure projects and privatizations have gone

forward in several countries. Unbundling of “natural” monopolies has taken place in Argentina, which led the way in the 1990s with breakup and privatization of railroads, telephone, electricity, oil, natural gas, water supply and civil aviation, ending decades of huge subsidies to state corporations. The same trend is underway in Bolivia, Brazil, Colombia, Mexico, Peru and Venezuela.

It may be that a new institutional environment is being created. If so, its strength will be tested by conflicts between globalism and localism. In Brazil The first major test is in the unbundling and privatization of the state electricity monopoly, with asset value of \$90 billion and annual revenues of \$15 billion. The forces of globalism emerge through the urgent need for new investment to meet the needs of economic growth. The forces of localism are felt in political and bureaucratic resistance to privatization and in the slowness in developing policy and rules over tariffs and over unbundling the functions of generation, transmission and distribution of electricity that are now concentrated in government monopolies. The forces of globalism and localism will contend with each other in future fights over tariffs and regulation, as they have in the past. Nobody knows how the new institutional environment will develop.

Brazil is different from the rest of Latin America in that it belongs to the exclusive club of “monster countries,” to use George Kennan’s unflattering term, whose other members are the United States, China, India and Russia, inward-looking nations of continental dimensions and big populations, embracing together 46 million square kilometers and nearly half the world’s population. Maddison finds “little evidence that big countries have much of a scale advantage” with “no significant relationship between size and productivity performance....Most of the benefits of specialization and scale can be obtained by small countries through international trade.” All big countries need extra administrative machinery to manage complex federal systems spread over vast territories. All must struggle to avoid deterioration of extensive transportation infrastructures requiring expensive maintenance, especially in regions of low population density. All of them are historically ambivalent in dealing with the rest of the world. Russians have been divided over “Westernization” for at least three centuries, since the reforms of Peter the Great. While the United States is the only “monster country” that has globalized its economy, perhaps because its market and corporations drive the globalization process, its leaders nursed mixed feelings over entanglement in foreign affairs since gaining Independence two centuries ago. As recently as 1970, the United States had the same low import coefficient as Brazil’s, of less than 4% of GDP. For at least a thousand years, China has been the paragon of self-sufficiency, returning to autarchy after suffering humiliations at foreign hands in the 19th and early 20th Centuries. Even today, China’s economic opening is limited to a small part of the country, attracting huge flows of foreign investment that still feed suspicion and ambivalence.

Brazil is fortunate among the big countries in that its linguistic and ethnic frictions are much less of a threat to political cohesion than in the others. But its ambivalence toward globalization raises important questions: What are Brazil’s prospects in a globalized economy? What are its comparative advantages? What conditions must Brazil create so that access to world trade and capital flows can help to solve internal problems of employment, productivity, public investment, social protection and living standards? Can Brazil’s private entrepreneurs mobilize the initiative and creativity to produce more satisfactory levels of economic development? Unfortunately, Brazil’s debate over globalization rarely addresses these issues.

In one of the few serious research efforts on the effects of Brazil’s opening to the world economy, economists at the BNDES (National Bank for Economic and Social Development) found that “the impacts of opening went in the expected and desired direction. Given the industrialization strategy pursued in the past, a substantial increase in import coefficients and a general fall in industrial profit margins were inevitable and healthy, in terms of both welfare and economic growth. Import-substitution industrialization promoted an excessive number of sectors in relation to available resources and bred inefficient market structures that survived only thanks to high protection.” There has been some loss of industrial jobs, especially in São Paulo. This may be part of a worldwide trend of rising manufacturing productivity and a shift into employment in services and the informal sector. This world trend is compounded by a move of Brazil’s industries away from the megalopolis and by

failure of state and local authorities in São Paulo to manage problems of scale and to invest in public transportation, health and education, failures issuing from the civilizational problem of chronic inflation. The economic opening stimulated a big rise in industrial productivity, generating higher wages and lower consumer prices for manufactures.

To support their conclusions, the BNDES economists presented these facts: While Brazil's trade balance in manufactures shifted from a \$15 billion surplus in 1989 to a \$1.5 billion deficit in 1995, these effects were unevenly distributed among different industries and represented a small share of total production. The hardest-hit was the capital goods sector, which was in deep trouble since the early 1980s and saw imports rise from 11% to 59% of production in 1989-95, roughly the same as before intensive import-substitution began in the 1970s, while the sector's exports also grew from 7% to 17% of output. However, other industries —beverages, pharmaceuticals, cellulose, soaps, perfumes, dairy products, electrical appliances, automobiles, cement— benefited from big increases in domestic demand, driven by a 27% rise in average real wages since the Real Plan was launched in July 1994. Poor people now are buying more electrical appliances and consuming more milk, meat and other forms of protein than they did three years ago. Big increases in imports as a share of consumption took place in machinery, telecommunications equipment, fertilizers, chemicals, auto parts, textiles and automobiles. Brazilian manufacturers complain that an overvalued local currency, cascading taxes and high interest rates raise their costs at each stage of production and distribution, impeding them from modernizing and competing with goods produced abroad with low-interest financing and imported at low tariffs. The BNDES economists warned that freeing trade while allowing domestic currency to appreciate poses great risks to the economic opening and urged “a return to a trajectory of real devaluation of the exchange rate.”

Under political pressure, the government granted a 70% special tariff to protect foreign car manufacturers operating in Brazil, a level of protection they could never dream of obtaining in their home countries. While others pay the 70% tariff to import vehicles, companies producing locally could import built-up cars and trucks at a 35% duty. Moreover, barriers were removed from the previously-protected Brazilian auto parts industry to strengthen the competitiveness of local assembly plants.

These are mixed results determined more by past and present government policies than by outside forces. However, these results add pressure on Brazil to adjust its cost structure to win a larger share of concentrated production and marketing capacity to gain wealth and efficiency from an expanding global economy. If Brazil wants to participate more fully in this expansion, we must develop a clearly defined trade strategy that strengthens our export capacity. If Brazil wants to attract the foreign direct investment that drives globalization, we must take into account the factors that investors weigh most in selecting a location: market-size, economic predictability, stable legal and political rules and prospects for profit. Until recently, these factors were missing in Brazil or were not sufficiently developed. Another obstacle is the high cost of doing business in Brazil, known as the *Custo Brasil*, bred by market distortions and deterioration of highways, telecommunications and electric power facilities. Lack of stable financial and institutional mechanisms for providing and renewing modern infrastructure threatens a vicious downward spiral of decapitalization: deficient investment and maintenance sabotages the viability of existing infrastructure, discouraging in turn new investment in other industries. Other elements of the *Custo Brasil* range from inflexible labor laws that discourage hiring and firing of workers and create a huge gap between the total cost of employing people and a worker's take-home pay; slow judicial procedures; a school system that fails to prepare the population to work in a modern economy, and low productivity and high costs of cartelized ports. Today some of these things are changing, but several economic sectors remain fortified against efficiency improvements and foreign investment. The World Economic Forum's Global Competitiveness Report 1996, using indicators of institutions, infrastructure and economic policy, ranked Brazil 48th among 49 nations in competitiveness, behind Venezuela and ahead only of Russia. These rankings may be tendentious and distorted, based on questionnaires mailed from Switzerland and filled out with varying degrees of care and objectivity by thousands of people in different countries. They seem at odds with the size of

Brazil's internal market, its pool of business skills, its agricultural and industrial capacity and its ability to attract foreign capital. However, these rankings usefully warn us of institutional weaknesses that threaten economic progress. UNCTAD observes that, with trade barriers now lower, "the size of national markets has decreased in importance. At the same time, cost differences between locations, the quality of infrastructure, the ease of doing business and the availability of skills have become more important."

What makes the difference between success and failure in development is not abundance of natural resources. These privileged endowments occur in such diverse countries as Brazil, Zaire, Russia and the United States. The critical difference is in investment in human resources and, above all, the quality of public institutions that includes not only the political system but also the legal and regulatory complex that create conditions for markets to function. Nobody today denies that the great engine of development is the market. But the market needs a minimum of legal and macro-economic stability that only can be supplied by the State. Brazil will make its choice about globalization. The choice will be shaped by the quality of its public institutions and perceptions of its own self-interest.

[Home](#) | [Biography](#) | [Publications](#) | [Publication List](#) | [Contact](#)  
[ngall@braudel.org.br](mailto:ngall@braudel.org.br)