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Southwest Economy

Is Mexico Ready to Roar?

Mexico has become a much more open economy over the past 20 years. And since the 1994 financial crisis, Mexican authorities have shown a commitment to macroeconomic discipline.

Given this progress, many observers are enthusiastic about the country's prospects. Some, in fact, wonder whether Mexico is about to take off and become the world's next economic tiger. The evidence suggests, however, that much work remains to be done before Mexico can catch up to First World nations the way countries such as Singapore and South Korea did in the last few decades.

Until the early 1980s, like most developing nations, Mexico sharply restricted foreign investment and trade in hopes of expanding domestic production capacity. But a severe financial crisis in 1982 prompted a change of tactics. Foreign investment limits were lifted in 1983 in some sectors. In 1985, Mexico announced it would join the General Agreement on Tariffs and Trade and did so the following year. Between 1985 and 1990, the country's maximum tariff fell from 100 percent to 20 percent. Most sectors were opened to foreign investment in 1989, paving the way for a successful wave of privatizations. By 1994, 80 percent of

(Continued on page 2)

Welfare Reform Revisited

In the late 1980s, the number of people receiving welfare benefits in America began to rise. As the trend continued into the 1990s, a bipartisan coalition searched for ways to reform the American welfare system. Convinced that many welfare recipients could work if presented with appropriate incentives, political leaders devised a welfare reform bill that was intended to promote self-sufficiency while retaining a social safety net for those who temporarily have no other options.

The bill was intensely controversial. An influential policy adviser said the bill would inflict "serious injury to American children."[1] A senator who specializes in welfare issues said there was "absolutely no evidence that this radical idea has even the slightest chance of success."[2] And the Center on Budget and Policy Priorities predicted that the most significant effect of welfare reform would be "a large increase in poverty."[3]

(Continued on page 5)

state-owned firms had been privatized. The icing on the cake came in the early 1990s with the implementation of NAFTA, which secured Mexico's access to North American markets.

Mexico's Transformation Triggers Foreign Investment and Trade

This open policy has paid off. Among developing nations today, only China and Brazil receive more foreign investment. In the past 20 years, foreign investment—most of it from the United States—has exploded (*Chart 1*).

Today, firms that receive foreign direct investment account for over 20 percent of all employment in Mexico. Naturally, not all regions have benefited equally. In border states like Chihuahua and Baja California, this employment share exceeds 50 percent. But southern states like Chiapas and Oaxaca have been largely left out. In terms of economic sectors, manufacturing leads in foreign investment, followed by financial services. Within manufacturing, the maquiladora sector accounts for a third of all foreign investment.

Exports have surged as well. Mexico's exports-to-GDP ratio has tripled since 1980, with manufacturing exports—fueled by foreign investment—accounting for most of the boom (*Chart 2*). Manufactured goods have replaced primary resources as Mexico's main export.

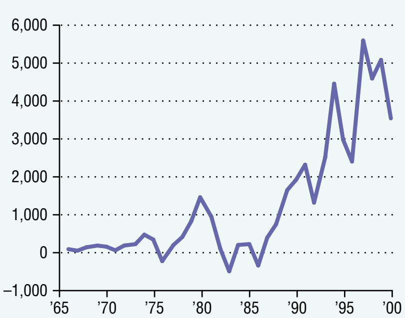
The United States continues to account for the bulk of Mexico's exports and investment inflows. It is the destination of almost 90 percent of Mexico's exports and the source of three-quarters of all foreign investment. As a result, Mexico's economic performance depends more than ever on U.S. economic activity. Between 1994 and 2000, the U.S. expansion enabled Mexico to grow faster than any other Latin American economy. When U.S. manufacturing began slowing in fall 2000, Mexico's six-year expansion ended in synchronicity.

Chart 1

Foreign Investment in Mexico Explodes

Net U.S. direct investment

Billions of U.S. dollars

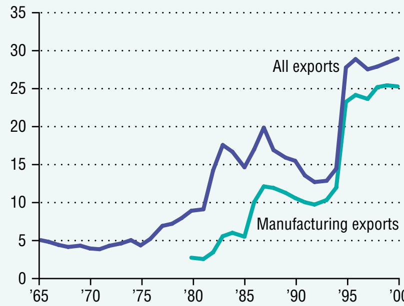


SOURCE: Bureau of Economic Analysis.

Chart 2

Mexican Manufacturing Exports Take Off

Percent of GDP



SOURCES: Banco de México; International Monetary Fund.

Still Not a Success Story

Despite the recent slowdown, Mexico is now Latin America's largest economy in U.S. dollar terms, suggesting that the foreign trade and investment boom is translating into higher economic growth. In light of all the good news, it is tempting to ask whether Mexico is on the brink of becoming the next development success story.

Unfortunately, Mexico's performance since 1994 can't hide the fact that much work remains before it catches up with First World economies. Real GDP per capita almost doubled between 1965 and 1982, and the country was described as an economic miracle. But the downturn in oil prices and a series of financial crises brought the miracle period to an end. Mexico's real GDP per capita today is roughly what it was 20 years ago.

Why haven't the sweeping policy changes of the past 20 years enabled Mexico to pick up where it left off in 1982?

Long-run growth requires an expansion of production capacity. Nations accomplish this by mobilizing more physical and human resources and becoming more productive by, for instance, allocating resources better. Several East Asian countries that were very poor in the 1960s caught up with the industrialized nations in about two generations by doing this. These economic tigers include small countries like Singapore and fairly large ones like South Korea.

Consider South Korea. In 1965, its income per capita was half of Mexico's (*Chart 3*). By the late '80s, however, Korea had overtaken Mexico and is now about twice as rich as its Latin American counterpart. As with the other tigers, Korea experienced an export boom, and its exports-to-GDP ratio has quadrupled since 1970 (*Chart 4*). Manufactured goods accounted for most of the trade expansion, as was the case for all the tigers. In this respect, at least, Mexico does look like a tiger.

But the key to development, and the area where Mexico falls short, is finding a way to quickly expand production capacity. MIT economist Alwyn Young is credited with establishing that on a basic level, the tigers' economic performance is no mystery.[1] The East Asian tigers, he showed, grew the way they did because they mobilized physical and human resources at a mind-boggling rate.

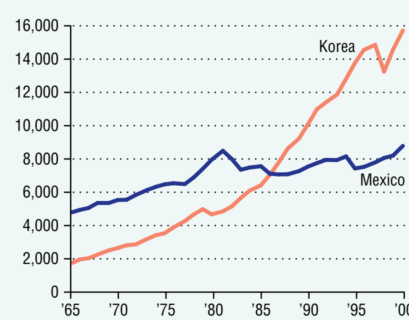
Again, consider South Korea. Its investment-to-GDP ratio reached almost 40 percent in the late '80s, very high by international standards (*Chart 5*). Interestingly, foreign investment did not play

Chart 3

Korea Overtakes Mexico

Real GDP per capita, adjusted for purchasing power

1996 U.S. dollars

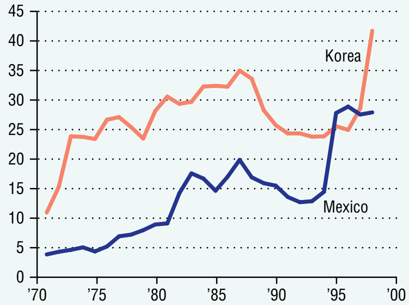


SOURCE: Penn World Tables 6, Organization for Economic Cooperation and Development.

Chart 4

Korea Experiences Export Boom

Percent of GDP



SOURCE: International Monetary Fund.

a big role in this. The investment surge was financed through exceptionally high private and public domestic savings. By contrast, Mexico's investment rate, in spite of the recent influx of foreign money, has hovered around 20 percent for most of the past 30 years.

South Korea's fastest growing resource has been human capital. In 1960, almost half the working population lacked a primary school education (*Chart 6*). Today, 70 percent of working Koreans have at least some secondary education. Mexico's achievements in this area remain dismal. A third of the working population has not completed primary school, and the country today stands roughly where Korea did 40 years ago.

Making a Tiger Out of Mexico

As Nobel Prize economist Robert Lucas once wrote, "If we know what an economic miracle is, we ought to be able to make one." Why can't Mexico replicate what Korea did?

Several factors that contributed to the success of the East Asian tigers may be impossible to replicate. For instance, the savings rates they achieved may not be attainable or even desirable for most emerging nations.

Nevertheless, all developing nations can learn from the East Asian experience. The tigers provided several conditions conducive to the accumulation of physical resources. In most cases, they committed early on to monetary and fiscal discipline and provided predictable macroeconomic conditions for investors. They also provided fairly efficient, stable institutions, such as well-functioning legal systems. As for human capital, the tigers made a major effort to supply basic education and health services during early stages of their catch-up period. Mexico has much work to do in all these areas.

Fiscal Uncertainty

Since its 1994 financial crisis, Mexico has made progress in macroeconomic discipline, bringing inflation down to its lowest in 30 years and fiscal deficits to below 1 percent of GDP. But the government continues to depend on unpredictable oil sales for more than a third of its revenues. The government has been able to trim spending recently, but in the long run, a credible commitment to fiscal and monetary discipline demands that Mexico reduce its dependence on oil revenues. Bond prices plunged recently when Finance Minister Francisco Gil Diaz likened Mexico's fiscal situation to Argentina's. The administration has since tried to reassure financial markets, but Gil Diaz's words struck a sensitive chord.

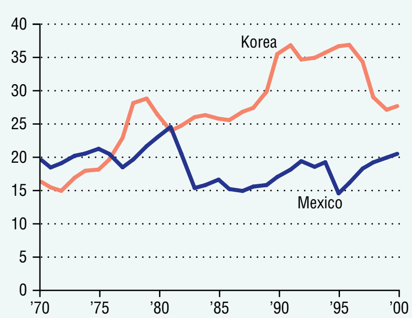
Why is it so difficult for Mexico to find more reliable sources of public revenues? Although tax rates are not low by international standards, many individuals and corporations avoid income taxes altogether, making the tax base small. In Mexico, the informal sector accounts for an amazing 50 percent of employment. As a result, Mexico's tax-to-GDP ratio is markedly below Korea's and the United States'. In fact, it's low even by Latin American standards.

Chart 5

Korea Enjoys Investment Surge

Gross fixed investment

Percent of GDP



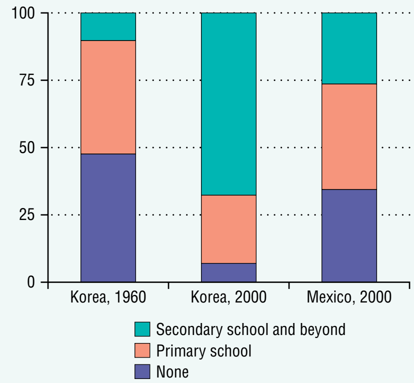
SOURCE: Organization for Economic Cooperation and Development.

Chart 6

Mexico Lags Korea in Education

Educational attainment of working population

Percent



SOURCE: Robert J. Barro and Jong-Wha Lee, "International Data on Educational Attainment," Working Paper no. 42, Center for International Development, Harvard University, April 2000.

Inefficient Institutions

Ill-functioning institutions add to the unpredictability of Mexico's business environment. The biggest problem is that property rights are not effectively enforced because of an inefficient legal system. According to recent estimates, collecting on a bad check takes five times longer in Mexico than in the United States. Resolving more complicated contractual disputes can take several years.

This poor legal environment has many negative consequences. Maybe the most detrimental for growth, and a key reason investment has stagnated, is the impact on the financial sector. Mexican banks are very hesitant to lend in an environment where contracts are not properly enforced. Chart 7 shows the ratio of loans to the private sector to GDP in the past 40 years in Mexico, Korea and the United States. Mexico's financial sector is very small and, if anything, getting smaller. In a recent World Bank survey, over half of Mexican firms described their access to financing as severely limited, compared with 15 percent of U.S. firms. In Singapore (Korea wasn't surveyed), only 10 percent of firms reported that they face the same situation.

To make matters worse, even when they can secure financing, Mexican entrepreneurs face burdensome regulations and a notoriously inefficient bureaucracy.

For example, it takes more than 65 days on average to register a firm in Mexico, compared with four days in the United States.

On the education front, Mexico's poor performance is not due to low spending but to its failure to emphasize basic education. Korea made an early commitment to basic education, and in 1970, two-thirds of the country's educational spending was allocated to preprimary and primary education (*Chart 8*). As recently as 10 years ago, only a third of Mexico's education budget was allocated to preprimary and primary education. This share has increased to one half in recent years, but it will take a generation for these efforts to begin paying off.

The government must find a way to diminish its reliance on oil revenues, perhaps by emphasizing consumption taxation.

Toward Long-Term Growth

So what will it take for Mexico to start growing like a tiger?

First, the government must find a way to diminish its reliance on oil revenues, perhaps by emphasizing consumption taxation, since income taxation has failed to generate sufficient revenue. Consumption taxation has already shown great potential in Mexico. When a limited value-added tax (VAT) was introduced in 1978, the tax-to-GDP ratio increased by 5 percentage points in two years. President Fox's attempts to expand the VAT base failed last year because he was unable to assuage concerns that the reform would hurt the poor. Increased welfare spending may prove necessary to pass the fiscal reform Mexico needs.[2]

Second, Mexico must improve the country's institutions. Mexico can learn from the tigers, which made civil servants' recruitment and promotion merit-based and their pay competitive with the private sector's. As for the judiciary, research suggests that simply devoting more resources to the sector does little to reduce court delays. On the other hand, devoting a larger share of resources to the reduction of procedural times can prove very effective, as Peru demonstrated in 1995.[3]

Third, Mexico must continue fighting its human capital deficit by targeting basic education.

Daunting as they may sound, these are only some of the steps needed to achieve long-term development. As with many other Latin American nations, Mexico direly needs labor market and energy sector reforms. But although much work remains to be done, the potential benefits are enormous.

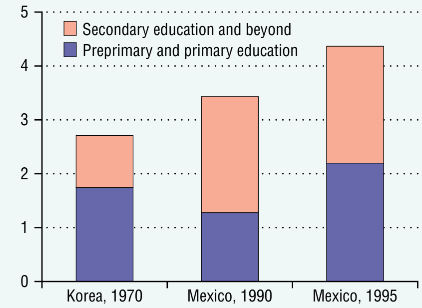
—Erwan Quintin

Quintin is a senior economist in the Research Department of the Federal Reserve Bank of Dallas.

Chart 8

Mexico Slow to Push Basic Education

Percent of GDP



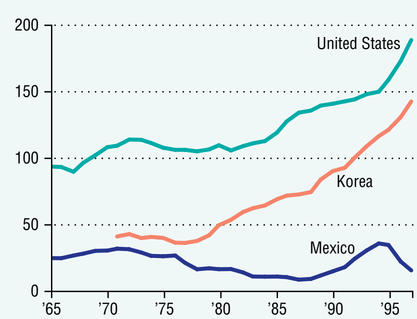
SOURCES: UNESCO; International Monetary Fund.

Chart 7

Mexico's Financial Sector Is Small

Loans to private sector

Percent of GDP



SOURCE: International Monetary Fund.

Notes

The author thanks Eric Millis for his research assistance.

1 Alwyn Young (1995), "The Tyranny of Numbers: Confronting the Statistical Realities of the East Asian Growth Experience," *The Quarterly Journal of Economics* (110): August, pp. 641–80.

2 Erwan Quintin (2002), "Mexico's Lawmakers Begin to Confront a Taxing Issue," *The Dallas Morning News*, Jan. 22, p. 27A.

3 Maria Dakolias (1999), "Court Performance Around the World: A Comparative Perspective," World Bank Technical Paper no. 430.

Welfare Reform Revisited

(Continued from front page)

Over these objections, President Clinton signed the Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA) into law in August 1996. And in the years following passage of the law, welfare recipiency has declined significantly—without a corresponding increase in the poverty rate. Many observers now cite welfare reform as one of the most successful policy experiments in a generation. In the words of President Clinton, the welfare system has become "a second chance" instead of "a way of life."

Because PRWORA expires on Sept. 30 unless renewed by Congress, it is an opportune time to examine the law's effects and draw lessons for its future. This article looks at the structure of the law, details its results and discusses what is likely to happen later this year when the law is reauthorized.

What Did the Welfare Reform Law Do?

The welfare reform law focused on the Aid to Families with Dependent Children (AFDC) program, which was the cash-grant portion of America's social safety net. (The box "A Brief Description of the U.S. Welfare System" describes the other portions of the safety net.) The law replaced AFDC with a program called Temporary Assistance to Needy Families (TANF) and made four major changes to the welfare system.

The first—and perhaps most significant—change was a requirement that recipients work in exchange for their cash benefits. Previously, recipients were required to make only a minimal effort at finding employment. Under the new system, many of those who received benefits for more than two years lose their cash grant unless they perform a work-related activity for at least 30 hours per week. Private employment is one way to fulfill the requirement, but education or training can generally also be counted as work for purposes of this legislation.

Second, the law imposed a five-year lifetime limit on the amount of time any single family can receive cash benefits. Previously, it was possible to spend a lifetime on the welfare rolls, which led many analysts—and more than a few welfare recipients—to conclude that welfare created a "cycle of poverty" from which welfare families could never escape. Under the new system, all but the most hardship-stricken recipients are permanently barred from cash grants after five years even if the recipient remains outside the workforce. The idea was akin to FDR's vow that the welfare system would provide a temporary "hand up" rather than a permanent "handout."

Many observers now cite welfare reform as one of the most successful policy experiments in a generation.

A Brief Description of the U.S. Welfare System

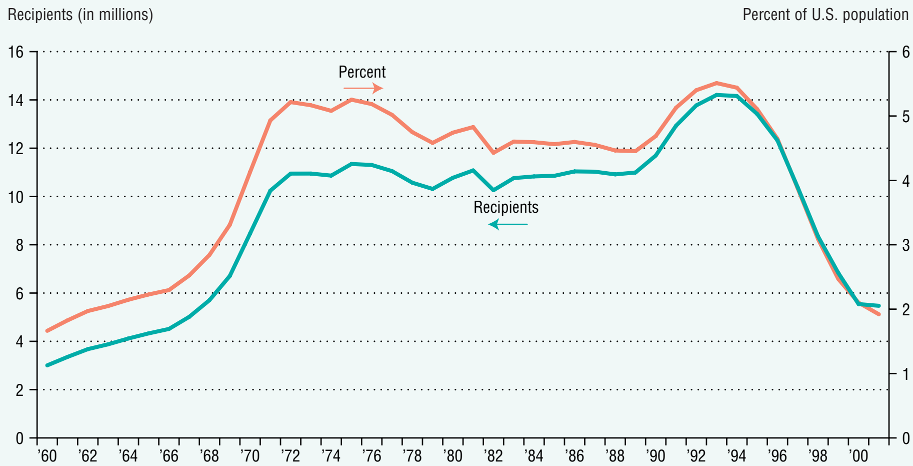
In the United States, many federal programs are available to help the poor, including programs to provide home heating oil, housing subsidies and even infant formula. But for our purposes, the U.S. welfare system consists of three major components: Temporary Assistance to Needy Families (TANF), food stamps and Medicaid. (A fourth program, Supplemental Security Income or SSI, provides significant support to the elderly and disabled but is not considered here.)

The programs differ in three respects: funding source, benefit type and scope of coverage. TANF (formerly known as Aid to Families with Dependent Children) gives cash benefits to poor families with children and is jointly funded by states and the federal government. The Food Stamp Program gives food vouchers to low-income individuals—including TANF recipients but also including many single workers with low-paying or seasonal work—and is funded by the federal government. Finally, Medicaid provides medical care to poor and near-poor individuals and is largely funded by the federal government, with some help from the states.

Many people believe that welfare is one of the largest areas of government spending, but the extent to which this is true depends on the definition of welfare. Cash grants through the TANF program amounted to $18 billion in 2001, slightly less than 1 percent of the federal budget. Food stamps took up an additional $19 billion (1 percent) of the federal budget, and Medicaid consumed $129 billion (7 percent) of the budget. Summed together, these programs are about half as large as the defense budget.

Chart 1

Welfare Rolls Decline Dramatically



SOURCE: The Administration for Children and Families.

Third, the law made it more difficult for noncitizens to receive cash benefits or food stamps. Previously, noncitizens who were legal permanent residents of the United States could access most of the safety net available to citizens, which led some observers to conclude that there was an incentive for impoverished residents of other countries to enter the United States and become welfare recipients. To guard against this possibility, the welfare reform law barred many noncitizens from either cash grants or food stamps, although these restrictions were later relaxed for some of those affected.

Finally, the law removed the cash-grant portion of the welfare system from the list of entitlement programs. Previously, anyone who met certain eligibility criteria had a legally enforceable right to cash benefits, regardless of the fiscal circumstances of states or the federal government, the number of people on the welfare rolls or how hard recipients tried to find alternative means of supporting themselves. Under welfare reform, individuals no longer have an automatic right to cash benefits simply because they are poor or have children.[4]

Did Welfare Reform Reduce the Welfare Rolls?

In the five years following passage of the welfare reform law, the number of individuals receiving cash grants declined by 56.5 percent, a result beyond the predictions of even welfare reform's most ardent advocates. The current welfare participation rate, a 35-year low, returns welfare recipiency to where it stood at the dawn of Lyndon Johnson's Great Society (*Chart 1*).

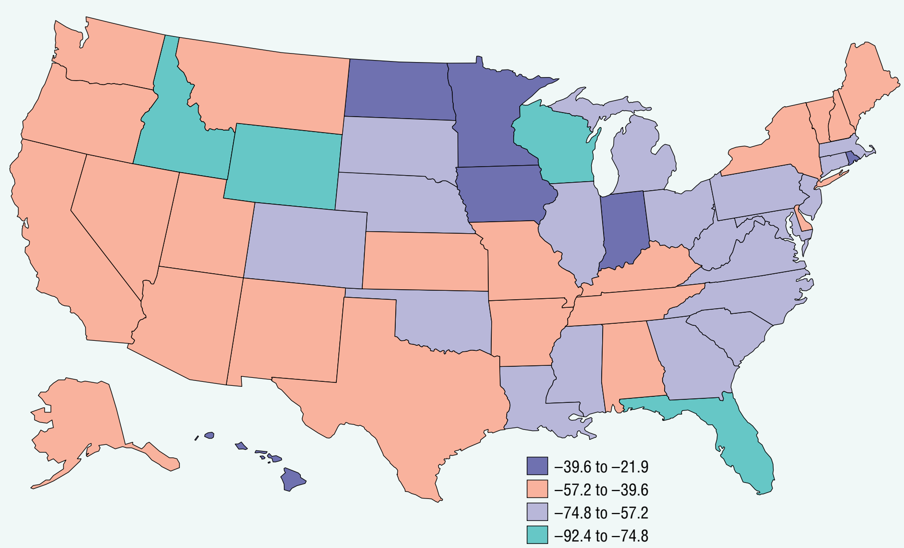
During the post-welfare-reform period, recipiency declined in all 50 states (*Chart 2*). The largest reduction (92 percent) occurred in Wyoming, which now has fewer than 1,000 recipients. Several large states also experienced significant success in cutting their welfare rolls, such as the 78 percent decline in Florida and the 72 percent decline in Illinois. The smallest reductions occurred in Indiana and Rhode Island, whose welfare rolls declined by 22 percent and 29 percent, respectively. Texas welfare rolls declined by 49 percent.

It may seem natural to credit the 1990s economic boom rather than welfare reform for this decline. But while the strong economy surely played a role, there are two reasons to think welfare reform was also important. First, the number of welfare recipients did not fall in other postwar economic expansions. Second, the number of people participating in other welfare programs did not fall by as much as cash-grant recipiency fell in the 1990s; food stamp recipiency fell by only half that amount, and Medicaid recipiency actually rose during the 1990s (*Chart 3*). This evidence suggests welfare reform was a significant contributor to the declines, a finding confirmed by a recent Council of Economic Advisers report.[5]

By itself, however, the reduction in welfare recipiency does not make welfare reform a successful policy experiment. Opponents of reform had made serious charges about how welfare reform "punishes the poor." If welfare reform slashed the amount states could spend on each recipient, if those who

Chart 2

Decline in AFDC/TANF Recipients, Fiscal Years 1996–2001

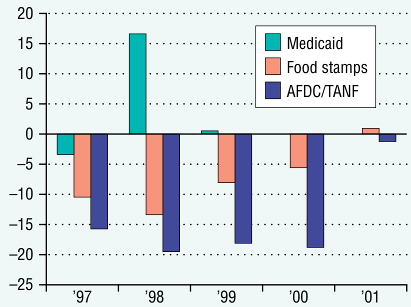


SOURCE: The Administration for Children and Families.

Chart 3

AFDC/TANF Shows Biggest Drop

Percent change in recipiency (year-over-year)

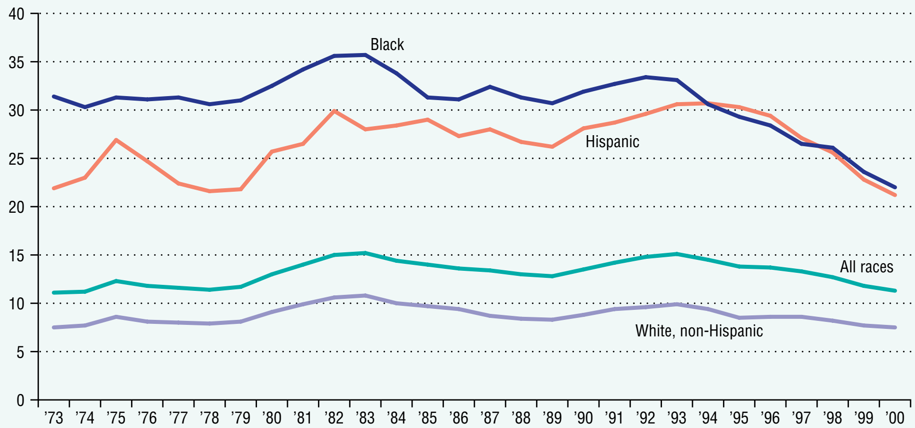


SOURCES: The Administration for Children and Families; Centers for Medicare and Medicaid Services; USDA.

Chart 5

Poverty Rates Decline for All Races

Percent below poverty level



SOURCE: U.S. Census Bureau.

left the welfare rolls were continually rebuffed in their job searches or if the poverty rate surged to new heights, the sharp welfare-roll reductions might be viewed as exacting a high social cost. On the other hand, if these outcomes did not occur, welfare reform might instead be viewed as one of the most successful policy changes of the 1990s.

On the spending side, per-capita outlays doubled between 1996 and 2001 (*Chart 4*) as recipiency plunged.[6] On the employment side, the General Accounting Office found that a majority of former welfare recipients have entered the labor force and continue to work today.[7] And the poverty rate for all races fell from 13.7 percent in 1996 to 11.3 percent in 2000 (the last year for which data are available) (*Chart 5*). Of special significance is the fact that the largest decline in the poverty rate during this period occurred among blacks, who form a disproportionately large share of the welfare rolls and were expected to have the most difficult time adapting to welfare reform. Taken together, the data suggest welfare reform proceeded in exactly the way President Clinton predicted when he signed the law: It encouraged many families to work without throwing many families into poverty.

Is There Anything Left to Reform?

Since the welfare rolls have already fallen by more than half over the past five years, it is inevitable that further reductions due to welfare reform will eventually slow. It appears this may be happening now: Cash-grant recipiency remained constant in the fourth quarter of 2001, and anecdotal evidence suggests it may have risen slightly in the first half of 2002. Absent further welfare reform, and especially at a time of economic weakness, the heady days of hundreds of thousands of new workers entering the labor force may be over.

At first glance, the legal changes wrought by the welfare reform law appear so sweeping that it is difficult to imagine what could be left to reform. Indeed, there is little doubt that the 1996 welfare reform law represents the most substantial reworking of America's social safety net since the 1960s. Welfare recipients must work. Welfare recipients must exit the rolls after five years. Many noncitizens cannot receive welfare benefits. No one is legally entitled to cash from the welfare system. However, a closer look at the provisions of the welfare reform law reveals broad exceptions to each of these stipulations, making the law less sweeping than it appears.

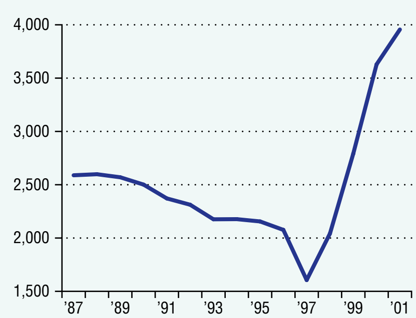
Recipients do face a five-year lifetime limit on welfare recipiency—but each state may exempt up to one-fifth of its welfare recipients from the ban if the state decrees those recipients to be hardship cases. Recipients no longer have an entitlement to cash assistance—but they continue to have an automatic right to food stamps and Medicaid, which form the majority of benefits for the typical recipient. And many legal residents are disqualified from receiving benefits—but not if they become U.S. citizens.

The work-requirement rule has the broadest set of exceptions. First, recipients are able to spend two years on the welfare rolls before they must work. Second, states may exempt up to half their welfare recipients from the rule. Third, states may calculate the maximum number of exemptions using either their current caseloads or their 1995 caseloads, which in practice allows some states to exempt almost every welfare recipient from the rule. Fourth, states may shift some of their welfare funds into a social services block grant, which can be given to recipients who do not meet work requirements. Finally, since states may define work to include many forms of education and training, even those recipients covered by the work-requirement

Chart 4

Spending Per Recipient Soars

Real dollars



SOURCE: The Administration for Children and Families.

rule need not work at anything resembling a private sector job to receive their cash grant.

Giving states discretion over these issues is not a problem in itself. Indeed, one of the greatest features of American democracy is that states act as laboratories of democracy, and many states have developed innovative ways to reach the targets set by the welfare reform law. However, since the amount of federal funding each state receives is partially determined by the extent to which it meets the welfare reform law's targets, states have a strong incentive to give numerous exemptions from the law's work requirements rather than encouraging recipients to work.

Some states, such as Wisconsin, have adopted innovative programs to encourage work. Others, such as Massachusetts—where only 9 percent of welfare recipients worked in 2001—have not. Statistical evidence indicates that welfare recipiency declined most sharply in states that strictly enforced the law's work requirements, which suggests that stricter limits on the use of exemptions would further reduce welfare recipiency. The question policymakers must now answer is whether states that do not wish to strictly enforce the law's provisions should be required (or encouraged) to do so.

What Happens Now?

Congress faces three possibilities for welfare reform. First, the welfare reform law could be strengthened to further reduce welfare recipiency, as discussed above. Second, the welfare reform experiment could be ended entirely and the system could return to the pre-1997 world in which needy families automatically receive benefits without federally imposed time limits or work requirements. Third, welfare reform could be retained as it currently stands, cementing the gains of the past five years without attempting to further reduce welfare recipiency.

In February 2002, President Bush released a welfare reform proposal that largely maintains the provisions of the 1996 law. Work requirements and time limits would remain, as would the restrictions on noncitizen recipiency and the non-entitlement status of cash welfare grants. Food stamps and medical care would remain entitlements, and funding would be maintained at current levels. States would retain much of the flexibility they currently possess.

However, the Bush plan would alter the 1996 law in at least two important ways. The first and most controversial is a proposal to implement stricter work requirements. States could exempt only 30 percent of their current caseloads (rather than 50 percent of their 1995 caseloads) from the work requirement. Also, the minimum hours a recipient must work would rise from 30 to 40, with 24 of those hours spent in a private sector or public sector job, and states would have less flexibility to define work. These changes would almost certainly reduce the welfare rolls still further, though with a weaker economy and a much smaller pool of welfare recipients, any further reductions would almost certainly not be as large as those achieved under the 1996 law.

The other main change from current law in the Bush plan is an effort to address the controversial issue of marriage. The welfare system currently provides a fiscal incentive to remain single because recipients can lose their benefits if they marry. To be sure, individuals base their matrimonial decisions on many factors other than the welfare system, so any marriage-related measures in the welfare reform law would be unlikely to have a very large effect on marriage rates. Still, while it seems clear that government should not compel anyone to marry, many observers believe it is appropriate for government to offset any unintentional bias the welfare system creates against marriage. As a first step, the Bush plan would allocate $300 million for as-yet-unspecified pilot programs to encourage marriage among welfare recipients.

At the time of this writing, the House has essentially approved the Bush proposal, while a Senate committee has approved something very close to the 1996 welfare reform law. The final version will likely fall somewhere in between, though a one-year extension of the 1996 law may be necessary while negotiators work out the details. Congress' action suggests that the broad policy prescription for the welfare system has been determined—the dramatic changes wrought by the 1996 law will continue in the years to come. What remains to be seen is how much further the 2002 law will go in reforming the welfare system—and reducing the welfare rolls.

—Jason L. Saving

Saving is a senior economist in the Research Department of the Federal Reserve Bank of Dallas.

Notes

I would like to thank Anna Berman, Pia Orrenius and Alan Viard for their comments and assistance with this paper. Any remaining errors are my own.

1 Peter Edelman (1997), "The Worst Thing Bill Clinton Has Done," *Atlantic Monthly*, March, pp. 43–58.

2 Sen. Daniel Patrick Moynihan, quoted in "Senate Approves Welfare Overhaul," *USA Today*, Oct. 15, 1996, www.usatoday.com/elect/ep/epd/epdc053.htm.

3 "The New Welfare Law," Center on Budget and Policy Priorities, August 1996, www.cbpp.org/WECNF813.HTM.

4 The funding mechanism also moved from a per-recipient grant toward a flat $16.5 billion per year, divided among states on the basis of how much they received under AFDC. However, supplementary grants and other provisions can add to this amount, so funding levels actually vary somewhat from one year to the next. For example, TANF expenditures rose from $13.8 billion in 1998 to $18.3 billion in 2001 even though the statutory allocation in both years was $16.5 billion.

5 The study, "The Effects of Welfare Policy and the Economic Expansion on Welfare Caseloads: An Update," suggests the welfare-reform law and the strong economy each substantially reduced welfare rolls in the late 1990s.

6 These figures include job training and other expenditures on behalf of welfare recipients, as well as cash.

7 While former recipients with limited skills and work experience typically begin in low-wage jobs, their labor market prospects can be expected to improve over time.

The Politics of Brazil's Financial Troubles

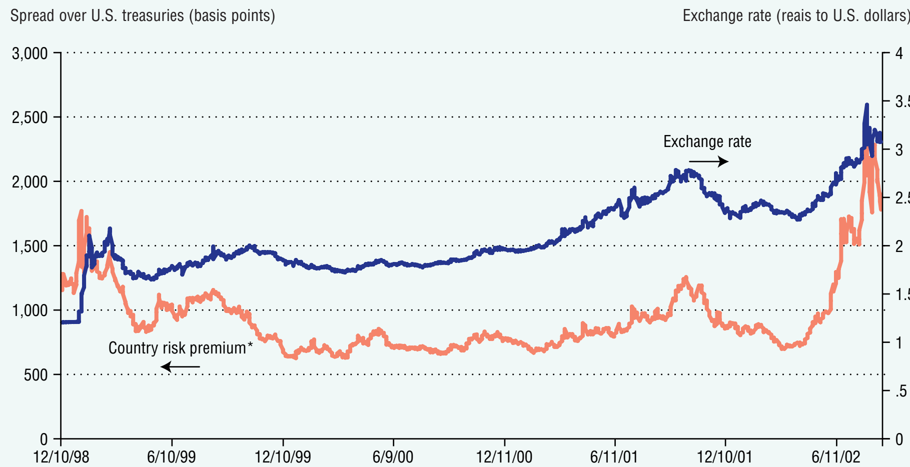
This year—and particularly since midyear—Brazil has suffered heavy financial pressures and large increases in the interest rates it must pay for foreign capital. In real-time economic terms, the reasons are difficult to analyze. Under the administration of President Fernando Henrique Cardoso, the nation's primary fiscal balance has improved markedly in recent years. Brazil's Fiscal Stability Program, which established goals for primary budgetary surpluses each year, has been in place since 1998. In each of the last three years, Brazil has exceeded its surplus target. Brazil is currently running a primary surplus of 3.75 percent of GDP, exceeding what would be required to stabilize the debt-to-GDP ratio.

In 2000, Congress enacted the Fiscal Responsibility Law, which forces public administrators to manage revenues, expenditures, assets and liabilities according to a set of clear and obvious rules. It imposes spending limits on public debt and personnel and sets fiscal targets for each year. It establishes rules to control public finance in election years, since that is when the temptation to run deficits is highest. Moreover, it imposes permanent fiscal discipline not just on the national government but on all levels of government.

Nevertheless, stresses are evident (*Chart 1*). Country risk differentials—the interest rate spreads between dollar-denominated Brazilian long-term debt and U.S. government debt of comparable duration—are higher now than they were during Brazil's 1998–99 crisis. And it now takes 34 percent more Brazilian currency to buy a dollar than at the beginning of 2002.

Chart 1

Brazil's Interest and Exchange Rates



*JP Morgan Emerging Market Bond Index.

SOURCES: Pacific Exchange Rate Service; JP Morgan.

Elections Bring Political Uncertainty

What, then, is the problem? Declines in U.S. equity markets have increased risk premiums across the world. The current Argentine crisis and other Latin American economic problems may have had some generalized increase of risk perceptions across the region, but Mexico's country risk differential increase has been tiny in comparison with Brazil's. The reason, as we will explain, is that investors are concerned about the possible future spending of whoever wins Brazil's October 2002 presidential election.

Understanding the impact of political uncertainty on Brazil's financial situation is a simple matter of accounting. Governments service their debt by issuing more debt, generating primary surpluses (holding spending other than interest payments below fiscal revenues) or issuing more currency. Nations unable to generate sufficient primary surpluses must eventually default on their debt or resort to inflationary finance. Like most Latin American countries, Brazil did both throughout the 1980s. The result was a "lost decade" of seemingly endless debt renegotiations and devastating hyperinflation.

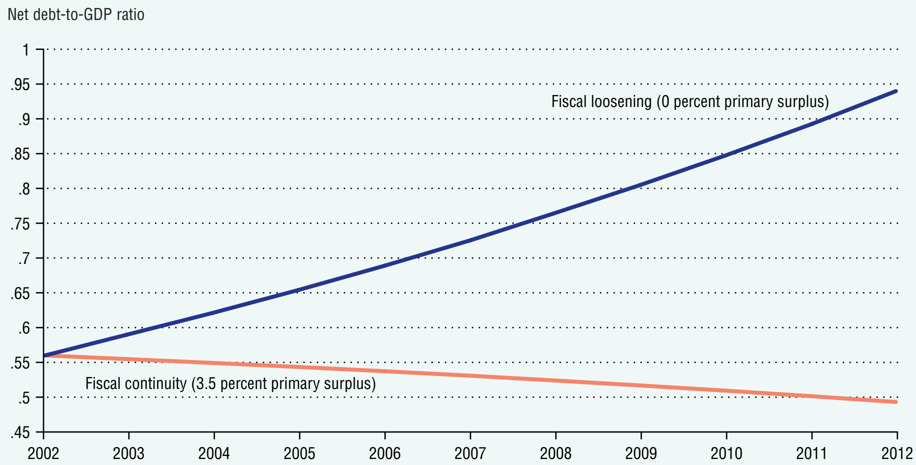
But today's Brazil differs markedly from its lost decade version. As we have mentioned, the Cardoso administration has managed to generate primary surpluses in excess of 3 percent of GDP since the end of 1999. In spite of these achievements, Brazil's debt-to-GDP ratio has yet to begin declining. It far exceeds its value at the beginning of the early 1980s. It also exceeds Argentina's ratio at the onset of its recent crisis.

But as Central Bank of Brazil economist Ilan Goldfajn points out, the steady rise in this key ratio since 1999 is due to the recognition of heretofore unrecorded government liabilities and to adverse movements in the real exchange rate. (About a third of Brazil's public debt is indexed to the exchange rate.) In fact, Goldfajn calculates that under "reasonable and even conservative hypotheses," maintaining current primary surplus levels should more than suffice to make Brazil's debt sustainable.[1]

Until two months ago, investors appeared to concur with this analysis. Between the end of 1999 and the summer of 2001, interest rates fell sharply as the success of fiscal reforms led investors to revise downward their evaluation of

Chart 2

Projected Evolution of Brazil's Net Public Debt



SOURCES: Banco Central do Brasil; authors' calculations.

default, inflation and exchange rate risks. Interest rates started rising again last fall in reaction to Argentina's woes but fell back when no signs of contagion materialized.

Since the end of May, however, interest rates have shot up to heights not seen since the 1998–99 crisis. While all emerging nations have been under some pressure, almost nowhere has the fall been so severe as in Brazil, where political uncertainty has compounded global shocks. Bond prices and the Brazilian real have dropped sharply with each new poll suggesting that José Serra, a member of the current administration who offers the best guarantee of fiscal continuity in Brazil, is falling behind in the presidential race. The two main beneficiaries of Serra's troubles—Luiz Inácio Lula da Silva and Ciro Gomes—are viewed as more likely to relax Brazil's self-imposed constraints on fiscal spending.

Chart 2 illustrates the impact of those concerns on Brazil's perceived solvency. It shows the projected evolution of Brazil's net debt-over-GDP ratio over the next 10 years under two distinct scenarios.[2] The first (the fiscal continuity case) assumes the primary surplus remains at 3.5 percent of GDP for the entire decade. The second (the fiscal loosening case) assumes the primary surplus falls to 0 percent and remains at that level. Like Goldfajn, we assume in both cases that the real economy grows at a 3.5 percent yearly rate and that average real interest rates are 9 percent a year.[3] We also assume no further real currency depreciation.

Chart 2 confirms that current primary surpluses would suffice to keep the public debt-to-GDP ratio from growing. But it also shows that absent those surpluses, this ratio would exceed 90 percent by 2012 under our growth and interest rate assumptions. In practice, default, inflation and exchange rate risk—and therefore interest rates—would rise with the size of the public debt, accelerating Brazil's drift toward insolvency.

In short, Brazil's public debt only appears sustainable if fiscal responsibility is maintained. The recent International Monetary Fund loan obtained by Brazil guarantees that current obligations can be met but will have no direct impact on the country's long-term solvency.

Candidates Pledge Fiscal Responsibility

There are reasons to believe that fiscal responsibility will prevail after the October election. First, not all hope seems lost for Serra. The latest polls suggest the administration candidate is beginning to make up lost ground. Debt and currency markets have stabilized accordingly.

Even if this comeback falls short, investors' concerns about the other presidential candidates may prove unfounded. Former union leader and current Workers Party candidate Lula da Silva has pledged to maintain economic and price stability. Although his party has challenged the Fiscal Responsibility Law in Brazil's Supreme Court, Lula da Silva's own platform includes a plank to maintain the nation's primary surplus.

The other candidate, Gomes, served as Brazil's finance minister in 1994 and has been governor of the northeastern state of Ceará. He, too, has pledged a program of fiscal stability. His proposals include a move away from income taxation of business and individuals and toward more consumption taxation. He wants to transition from Brazil's current U.S.-style pay-as-you-go social security program to a Chilean-style system in which each worker is individually capitalized. Although an important basis of support for both front-running candidates has been left of center, it is possible for a candidate with much left-of-center support to maintain a fiscally responsible government, as Chilean President Ricardo Lagos Escobar has amply demonstrated in recent years.

If nothing else, Brazilians are witnessing the devastating economic effects of Argentina's financial collapse, which adds credibility to the recent claims by presidential candidates that they will honor Brazil's financial obligations. Fiscal and monetary discipline requires political courage in a nation where a litany of social needs has yet to be addressed. But the threat of another lost decade could dissuade Brazilians from giving serious consideration to the alternative.

—William C. Gruben
Erwan Quintin

Gruben is a vice president and Quintin is a senior economist in the Research Department of the Federal Reserve Bank of Dallas.

Notes

1 Ilan Goldfajn, "Are There Reasons to Doubt Fiscal Sustainability in Brazil?" *Banco Central do Brasil Technical Notes*, no. 25, July 2002, www.bcb.gov.br/htms/public/notastecnicas/2002nt25fiscalsustainabilityi.pdf.

2 Like Goldfajn, we examine the evolution of net public debt rather than gross public debt. As Goldfajn explains, it is the evolution of the government's net liabilities that matters for solvency. He calculates that current general government credits amount to 21 percent of GDP. Concerns about the quality or liquidity of these credits could compound the impact of the fiscal shock we consider.

3 Real GDP has grown at an average yearly rate of 3 percent over the past two years, but the IMF forecasts a growth rate of 3.5 percent for 2003 (*World Economic Outlook*, April 2002, International Monetary Fund, www.imf.org/external/pubs/ft/weo/2002/01/pdf/chapter1.pdf).

Regional Update

Hopes of a recovery in the Texas economy are more distant than expected earlier in the year as July numbers confirmed a bleak employment picture. The 4.7 percent (seasonally adjusted, annualized rate) employment dip in July is the largest one-month decline in the past 10 years. It is important to note that large employment drops such as July's are often revised or offset by subsequent gains. Conversely, the January employment surge is likely to be revised downward.

Throughout 2002, service-producing sectors—trade, services and government—drove employment growth. This pattern was broken in July, when all sectors, including service-producing, shed jobs. Service-producing sectors lost a total of 33,500 jobs in July, accounting for 89 percent of the month's decline. Overall, Texas lost 37,600 jobs in July.

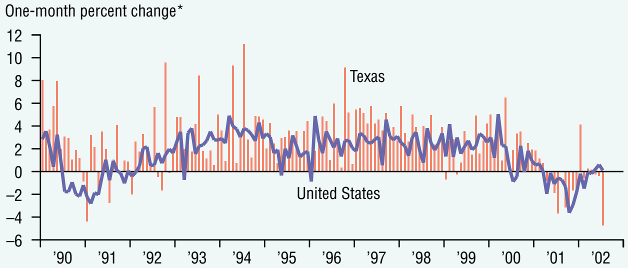
After enjoying two consecutive months of declining unemployment rates, all the Texas major metro areas saw jobless rates rise again in July. The increase was not unexpected because of seasonal adjustments. Of the major metro areas, Dallas registered the highest unemployment rate at 6.5 percent. Jobless rates along the border, although still the highest in Texas, continue to fall as job growth outpaces population growth. The overall Texas unemployment rate rose from 5.8 percent to 6 percent in July.

The Texas coincident and leading indexes are yet another negative indicator for the state's economy. The Texas Coincident Index has been slipping throughout the year, falling at an annualized rate of 1.1 percent since January. Prior to July, mild upward trends in the Texas and U.S. leading indexes signaled some improvement going forward. In July, however, both indexes turned down, suggesting a less promising outlook.

With the U.S. economy still struggling, Texas has limited opportunity for a rebound. What appeared to be a nascent recovery is now looking more like resistance to further economic deterioration.

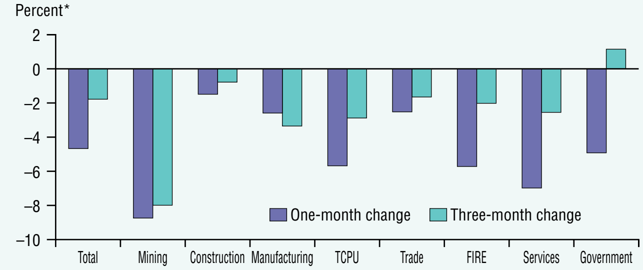
—Priscilla Caputo

Total Nonfarm Employment



*Seasonally adjusted, annualized rate.

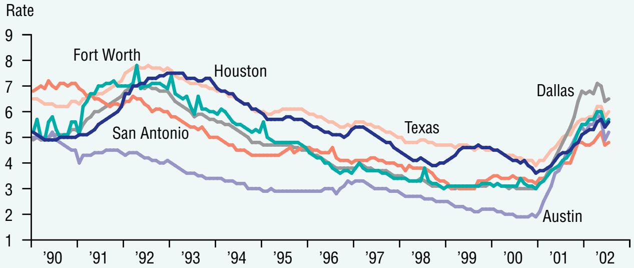
Government and Service Sectors No Longer Driving Growth



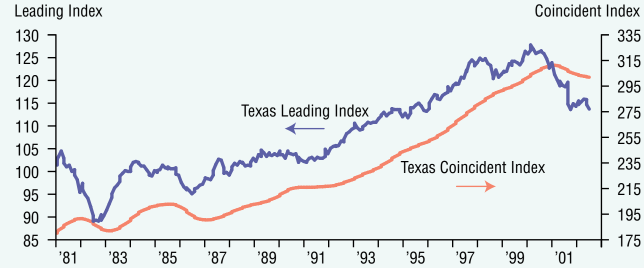
*Seasonally adjusted, annualized rate.

NOTE: TCPU is transportation, communications and public utilities; FIRE is finance, insurance and real estate.

Unemployment Rates Rise in July



Texas Leading and Coincident Indexes Pointing Down



Regional Economic Indicators

	Texas Leading Index	TIPI† total	TEXAS EMPLOYMENT* Mining	Construction	Manufacturing	Government	Private service-producing	TOTAL NONFARM EMPLOYMENT* Texas	Louisiana	New Mexico
7/02	113.7	—	156.8	558.6	1,004.0	1,614.9	6,085.6	9,419.9	1,913.6	761.1
6/02	114.7	125.4	158.0	559.3	1,006.2	1,621.7	6,112.3	9,457.5	1,916.7	762.5
5/02	115.8	125.3	159.3	559.9	1,009.7	1,614.4	6,117.2	9,460.5	1,919.9	761.0
4/02	115.9	124.7	160.1	559.7	1,012.6	1,610.3	6,119.6	9,462.3	1,921.4	761.1
3/02	115.3	124.1	159.5	560.0	1,014.0	1,609.8	6,117.6	9,460.9	1,923.5	762.5
2/02	114.7	124.4	160.8	559.4	1,018.0	1,606.7	6,113.9	9,458.8	1,922.9	762.9
1/02	115.5	124.5	161.7	561.1	1,024.8	1,603.4	6,112.3	9,463.3	1,926.1	762.2
12/01	114.3	125.4	161.9	559.7	1,024.5	1,597.2	6,088.3	9,431.6	1,925.5	758.3
11/01	114.9	125.9	162.7	559.4	1,027.9	1,594.4	6,101.5	9,445.9	1,925.7	758.1
10/01	113.6	126.8	163.0	559.0	1,033.1	1,592.7	6,111.3	9,459.1	1,926.7	758.5
9/01	114.8	129.0	163.7	561.4	1,038.9	1,592.4	6,127.3	9,483.7	1,924.0	756.3
8/01	119.6	130.0	164.5	564.0	1,047.6	1,584.3	6,148.4	9,508.8	1,928.2	756.3

* In thousands. † Texas Industrial Production Index.

For more information on employment data, see "Reassessing Texas Employment Growth" (*Southwest Economy*, July/August 1993). For TIPI, see "The Texas Industrial Production Index" (Dallas Fed *Economic Review*, November 1989). For the Texas Leading Index and its components, see "The Texas Index of Leading Indicators: A Revision and Further Evaluation" (Dallas Fed *Economic Review*, July 1990). Online economic data and articles are available on the Dallas Fed's Internet web site, www.dallasfed.org.

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