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Market Issues Pertaining to Poverty Reduction in Latin America

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Abstract

The extent to which Latin America can pull itself out of persistent poverty in the foreseeable future depends, in an important manner, on how successful the region will be in achieving sustainable growth in its rural economies. A good strategy for sustainable growth in rural Latin America is to make sure that the market works for the poor. The purpose of this paper is twofold. First, it is to lay out some of the issues important to the successful functioning of the key markets in rural Latin America, including labor market, financial market, land market, and agricultural factor and product markets. Second, it is to present policy suggestions regarding how to ensure that the market works for the rural poor. While governments should continue their refrains of not intervening directly with the market and distorting price signals, they can play a very positive role in facilitating market reforms and in ensuring that the rural poor indeed emerge as winners

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Market Issues Pertaining to Poverty Reduction in Latin America

Donald J. Liu[1]

Imagine a scenario in which, by the year of 2020, extreme poverty, hunger, and severe malnutrition have been eradicated in Latin America and income, wealth, and opportunity are more evenly and fairly distributed among people in the region. A pipe dream or a 2020 vision (Garrett)? Well, it depends on how successful the region will be in growing its economies between now and then and in what way the gains from the growth is to be distributed. Empirical evidence supports the notion that there exists a positive causal relationship between economic growth and poverty reduction (de Janvry and Sadoulet, Morley), and common sense dictates that growth can not be sustained unless the gains are distributed in an equitable manner, both intra-generationally (e.g., the poor vs. the rich) and inter-generationally (i.e., current generation vs. future generations).

While the food and agricultural system in Latin America comprises less than 25% of the region's gross domestic product[2], the vitality of agricultural sector is still of critical importance to the economic development of the region. This is particularly true of the region's most poverty stricken countries such as Bolivia, Guatemala, Honduras, and Paraguay, where 50% or more of the population still lives in rural areas. In fact, all over the subcontinent, poverty does not assume only an urban face, as 61% of the rural population is poor and more than half of the

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[2] It is less than10% in the region's larger economies such as Argentina and Mexico.

extreme poor live in rural areas.[3] To eradicate poverty and achieve economic equity in Latin America, one needs to address head on the economic woe of its rural economies.

With nearly all the countries in Latin America subscribing the free-market free-trade doctrine of the "Washington consensus" as the bedrock of their economic development strategies since the debt crisis of the early 1980s, the importance of well functioning markets to the sustainable growth of the region's rural economies cannot be overemphasized. The purposes of this paper are to lay out some of the issues important to the successful functioning of the key markets in rural Latin America and to present policy suggestions regarding the facilitation of the well-functioning of those markets.

The concept of "market" is defined broadly in this paper as an institution where economic forces are at work, and where the interaction of supply and demand has real consequences that affect the welfare of market participants including producers, consumers, and market intermediaries of the current and future generations. Due to imperfections arising from various market failings such as asymmetric market power (e.g., monopoly and oligopoly), asymmetric information (e.g., adverse selection and moral hazards), negative externality (e.g., downstream pollution), non-excludability (e.g., public goods), economies of scale (e.g., the provision of social services such as health care), excessively high startup costs (i.e., infant industry argument), and risk and uncertainty (i.e., missing or incomplete markets), the subscription of free-market free-trade development strategy should not be interpreted as the preclusion, *a priori*, of possible government involvements in the market place. However, past experience in Latin America clearly suggests that the involvement of governments should be limited to the promotion and regulation of free and competitive markets, and to the provision of

[3] The 61% figure can be compared with the 39% pertaining to the cities.

goods and services where markets fail (de Janvry et al.). In modifying the behavior of market participants and, hence, market outcomes, policies should be designed in such a way that the interventions rely on market incentives (e.g., tax and subsidy) rather than coercion (e.g., rationing or state ownership).

The market issues that will be discussed in the paper include those pertaining to (i) the rural labor market, (ii) the rural financial market, (iii) the rural land market, and (iv) the agricultural factor and product markets. Labor is the only productive asset that the rural poor in Latin America have in abundance. A major problem facing those rural poor is their limited access to other productive assets such as land and capital, with which to alleviate poverty and raise income. While most Latin American countries are relatively abundant in land endowments, a large proportion of their rural population is landless and has no ability to overcome the barriers imposed by imperfect rural lending institutions to raise funds for land acquisition and production projects. The economic hardship of the landless is made worse by the region's imperfect labor markets which have contributed to the underutilization of the only resource that the rural poor have in abundance (Carter and Zegarra). To arrive at effective and sustainable policy interventions to redress the problems associated with failings in land markets, rural labor markets, and rural financial markets, one needs to understand first the intricate linkage among the three. Since the goal of accessing productive assets is to generate income via production activities, the well-functioning of input and output markets in the agricultural sector and in the ensuing downstream value-added industries are also of importance to the alleviation of poverty in rural areas.

Clearly, there are other markets which are also critical to the development of rural economies in Latin America, but will not be treated here in this paper. Examples of those

omitted markets include water markets, technology and information markets, and international markets. It is generally held that, with the rapid urbanization underway, water will become one of the most constraining factors in agricultural production for the foreseeable future (IFPRI). It is also the received wisdom that, while productivity gains for the moment will continue to rely heavily on conventional improvements in animal and plant breeding as well as chemical technologies, further developments in biotechnology will have the potential of offering significant benefits for Latin America (Trigo). Since those benefits are likely to be differential with respect to operational scale, the challenge is to come up with innovative market institutions and infrastructures so that there will be enough gains for the rural poor. With the adoption of an export-led, free-market free-trade approach to economic developments and with the increasing trend for global and regional economic integrations (e.g., WTO, NAFTA, and MERCOSUR), the implication of international trade on the region's rural economies cannot be ignored in sectoral policy formations. However, since those topics will be discussed in some detail by other speakers, they are best left to the experts.

Some of the ideas discussed in this paper are available elsewhere in the literature and the author is in no position to claim their originality. Subject to the interpretation of the author, the sections on land markets and labor markets are best regarded as syntheses of a selected set of articles on the topics. In particular, the author benefits from the reading of de Janvry et al. and Carter and Zegarra. A citation list can be found in the reference section of this paper.

Rural Labor Markets

While the share of agriculture in total labor force is, on average, less than 25% in Latin America, it accounts for more than 35% in the lower-income countries such as El Salvador, Guatemala, Honduras and Paraguay. As pointed out by Valdés, the relatively low share of

agricultural labor force in the region's middle- and upper-middle-income countries implies that the urban sector has the potential of absorbing some rural workers without adversely affecting wages and unemployment in the cities. As such, economic developments in urban areas may hold the key to the solution of rural poverty in those countries. However, the much higher share of agriculture of total labor force in lower-income countries suggests that solutions to rural poverty in those countries lie on the expansion of labor income in the rural area itself. It follows that a key ingredient to the answer of rural poverty is the development of an active and healthy market for labor services. In addition to providing opportunity for the landless to generate cash income, an active rural labor market also allows smallholders to diversify their income sources and better utilize their own labor during off-peak seasons by working off-farm. Edwards notes that access to off-farm wage employment is an important avenue of poverty reduction.

The off-farm labor supply of a household is positively related to the off-farm wage and family size, and inversely related to the implicit on-farm wage and the level of non-labor income. Perhaps, what is surprising is the observation of a negative relationship between off-farm labor supply and the extent of land tenure insecurity. When individual title to land is absent, the heirs seek to buttress their claims by working and being seen to work regularly on the property. In this case, on-farm labor employment may exceed the level dictated by the equality between wage and the value of marginal product of labor, suggesting that titling programs are likely to increase the off-farm labor supply response to change in demand for labor in rural areas (Edwards).

Should the implicit on-farm wage be the same as the off-farm wage in the rural area? They should, if rural labor markets are perfect. Upon observing the fact that poor rural households in Latin America often have reservoirs of underutilized labor, Carter and Zegarra

argue that labor markets in rural areas are thin and imperfect, and that households have limited and irregular off-farm employment opportunity. The imperfection may arise from the fact that employers have market power in hiring, that rural workers lack the required skills for off-farm jobs, and that there are frictions in labor hiring due to institutional or social restrictions. Clearly, different intervention policies are required for different underlying reasons for the rural labor market imperfections.

Could it be that rural labor market imperfections are due to market power of the employers? If one is to accept the notion that rural and urban labor markets are economically integrated, one would be hesitant in espousing the market power argument. While labor markets in rural areas are geographically isolated from their urban counterparts, they need not be economically disconnected due to the direct link of rural-urban migration (transitional or permanent) and the indirect link associated with trade in goods and services. To the extent that rational arbitrage exists between rural-urban markets, conditions in rural off-farm labor markets should follow closely the labor market conditions in a larger geographical area, rather than dictated by the local employers. Empirical evidence appears to support the hypothesis of an integrated urban-rural labor market (Herrick, Fields). The ruling out of market power as the prime source of rural labor market imperfections suggests that the lack of off-farm job prerequisites may be the reason and that the solution is to heighten the education and skill level of rural workers.

On the other hand, if the rural labor market imperfections are due to institutional or social restrictions on labor hiring, the option is to remove those restrictions through legislative or other means. For example, as pointed out by Korzeniewicz, most countries in the region had had a history of government regulations that restrict women's employment, and in many cases these

laws are still in place. In addition to the direct effect of limiting labor force participation, these restrictions also have the indirect effect of increasing the cost to employers of hiring women rather than men. The decomposition of existing wage differentials between men and women suggests that a large proportion of the wage difference is left unexplained (Szasz, Gindling). There is also evidence that women in rural areas have a considerably lower labor force participation rate than their sisters in the city. Since women in rural areas are characterized by higher fertility rates than their urban counterparts, the lower labor force participation rate might be an outcome of the constraints created by childbearing and childrearing responsibilities (Korzeniewicz). As such, there is a role for the government to encourage, via market incentives, the development of quality childcare services in rural areas.

Finally, Lanjouw points out that there is the coexistence of two very different types of rural off-farm activities in Latin America and that policies designed for poverty alleviation should take into account of that taxonomy. The first category consists of jobs which are very poorly paid, with earnings below even the on-farm wages. Alongside such activities, there are high-productivity jobs, for which remunerations are also high. It turns out that the low-productivity low-remunerated jobs have the function of serving as a type of informal safety net for the rural poor as the same off-farm workers could have been much worse off had they not had the low-productivity jobs to begin with. On the other hand, the high-productivity high-remunerated jobs may be viewed as a vehicle with which the rural poor can directly pull themselves out of poverty. The author argues that in order to ensure the safety net, policy makers should balance cautiously the benefit of raising incomes of low-productivity low-remunerated jobs (e.g., mandating higher wages) against the social cost of introducing rationing to such jobs. On the other hand, government can be more pro-active and bold in expanding

access to high-productivity jobs by improving the provision of education and rural infrastructure, assuring competitive and fair markets for small-scale rural enterprises, and facilitating the effective labor market participation of poor rural households.

Rural Financial Markets

An essential ingredient for reducing poverty in Latin America is the development of properly functioning and soundly-regulated rural financial markets. The linkage is straightforward.

By being able to access to credit at reasonable interest rates and other terms, rural households can cope with transitory income shocks without having to resort to excessive precautionary savings and, hence, are in a better position to obtain working capital and to embark on profitable projects. The unavailability of credit would have forced the same rural households to invest in safer, lower-yielding agricultural activities. Murdoch reports that poor farmers diversify their crops more than rich farmers at the expense of mean earnings. A well-developed rural credit market, completed with safe and liquid financial instruments, would also facilitate rural households to move funds inter-temporally through savings which mobilize funds for rural projects.

Unfortunately, empirical evidence appears to suggest that a significant portion of the rural population may have been trapped in low-risk and low-return investment strategies because of the lack of access to reasonable financial services (Chaves and Sanchez). Further, in some part of the region the credit markets are highly segmented, as indicated by the existence of unexploited arbitrage opportunities, both across geographical areas and across groups of individuals with different social and economic statuses. The contributing factors to the rural financial market imperfections include an underdeveloped institutional infrastructure, dated

banking technologies (which hike transaction costs), legal and institutional limitations related to collateral requirements, and high interest rates. There are also institutional legacies restricting women's access to rural credit in spite of empirical evidence that women are better credit risks in micro-enterprises than men (Korzeniewicz). Finally, governments have been part of the problem. Chaves and Sanchez point out that the government's debt-forgiveness programs have promoted strategic defaults on the part of borrowers and discouraged the supply of credit on the part of lenders. Further, many governments have experienced strong political pressure to continue policies of lenient loan recuperation and rescheduling, and to maintain regressive interest rate subsidies (de Janvry et al.).

Despite all of its past failures, government can play a very positive role in the development of rural financial markets. Legislative means and economic incentives can be used to promote the arrival of a competitive market structure and a legal environment within which property rights, contracts and financial serves can prosper. To give access to smallholders to commercial financing using land and other assets as collateral, the process of property titling should be further streamlined and existing titling programs expanded beyond land to include other durables. Also, to encourage commercial banks to extend loan to smallholders, tax incentives can be granted to small rural loans to compensate for the correspondingly higher per unit transaction costs. In terms of mobilizing savings for rural projects, there is a need for sound government regulations and supervision of commercial banks so as to ensure and enhance confidence in these institutions of rural consumers. Finally, the governments would be well advised to provide incentives to private units to embark on research and development projects of new banking technologies to deliver more affordable financial products to small entrepreneurs in rural areas.

Rural Land Markets

Past land reforms notwithstanding, the ownership and operational distributions of land remain highly skewed and dualistic throughout most Latin America. Is market imperfection partially to be blamed? Because of the ability of smallholders to overcome moral hazards in labor efforts, there exists an inverse relationship between total factor productivity and farm size. For this reason, smallholders in Latin America are generally thought of as more efficient producers than their commercial counterparts. Despite of this superiority, market imperfections outside of the land market itself may have precluded smallholders from participating effectively in the land market. For example, if the rural financial market is imperfect, smallholders may be unable to purchase land because of credit constraints. This would eventually induce a dualistic process characterized by the concentration of land ownership in the hands of those with advantages in accessing capital and the atomization of operational units through tenancy contracts between land owners and peasant households who have an advantage in accessing cheap family labor (de Janvry et al.). Are there other market imperfections outside of the land market that can affect the performance of land market?

As pointed out earlier, the rural labor market may well be imperfect, given the off-farm labor sales constraints. Contrary to the financial market imperfection, however, the off-farm labor sales constraint dictates that smallholders may have a competitive edge in outbidding larger farmers in land purchases. This is because the labor market failure has the effect of rendering land especially valuable to resource-poor smallholders and, as a consequence, inducing them to use land more intensively, The result in a lower marginal return for labor and a higher marginal return for land of the smallholders, compared with their wealthier counterparts. As such, smallholders should have a greater willingness to pay for land and, if there is no

imperfections in other markets (e.g., in the financial market), they should be in a position to out-compete larger farmers in land acquisitions. Given the observed dualistic land structure, however, there are clearly countervailing forces that prevent the land market from evolving into the way predicted by the above simple, imperfect-labor-market model. We had mentioned previously the rural financial market imperfection as one possible countervailing force.

There are other forces against the use of land market as a mechanism to move toward a more equitable distribution of land ownership. As pointed out by Carter and Zegarra, transaction costs may have prevented resource-poor farmers from expressing their competitiveness in land market transaction. Two types of transaction costs are relevant here: the conventional fixed costs (e.g., registration fees and titling costs) and the subdivision costs. The fixed nature of the conventional transaction costs makes the effective price per hectare higher for resource-poor households than for large farmers. The subdivision costs make it expensive for smallholders to buy a small piece of land from a larger unit, effectively segmenting the market. Such land market segmentation would pose a barrier to inter-class land transfers, including those that are potentially efficiency-enhancing and poverty-reducing (Carter and Zegarra).

Land tenure insecurity is another countervailing force preventing the rural poor from effectively utilizing land market for redistributive purposes. A disproportionate number of smallholders, particularly in the Caribbean, maintain access to land through legally precarious and uncertain form of tenure. This creates uncertainties regarding continuous access to land which discourages long term investment and induces mining of the land. Further, land tenure insecurity among smallholders reduces their willingness to pay for the land and limits their ability to secure credit for land purchases. Additional countervailing forces include regressive tax policy and subsidy scheme. In many instances, production policies intended to promote

agriculture were actually biased against smallholders, who make up the great majority of producers. Instead, government policies gave generous benefits to the well-off, usually favoring certain types of land or landowner classes, including special access to subsidized credits or inputs and generous support prices. Binswanger argues that it is precisely the complex interaction among inflation, subsidy and taxation that skewed the distribution of land toward large holdings in Latin America.

Carter and Zegarra suggest that if the land market is to function as a vehicle for land redistribution, the following four areas of policy interventions should be considered. First, there is a need to reform the rural financial market so as to improve smallholders' ability in securing loans. Second, there is a need to develop innovative approaches such as the formation of land banks to combat problems associated with inter-class transaction costs in land markets. Third, there is a need to further strengthen the land tenure legislation to remove tenure insecurity. Finally, there is a need to provide long-term capital grants and subsidies to resource-poor farmers to overcome savings and financial constraints that may limit their entry into the land market.

Agricultural Factor and Product Markets

In a perfect world where goods flow freely across markets, price differential between any two markets of an identical good should equal the transaction costs of moving the good from the origin market to the destination market. For example, prices of agricultural commodity between two regions should differ by the corresponding transportation costs, between two time periods by the corresponding storage costs, and between two product forms by the corresponding processing costs. That is, upon accounting for the transaction costs of moving goods between related markets, the same good should command the same price in both markets. The reason the

"law of one price" comes about is because of the go-in-between of arbitragers who stand ready to take advantage of unexploited profit opportunities by moving goods between markets. When the "law of one price" holds, the market is said to be efficient in that identical goods are allocated in such a way that their marginal values are equalized across markets.

There is a set of conditions that must preexist in order for factor and product markets to function in an efficient manner. First, preexistence should be a set of market infrastructures that enable arbitragers to move goods between markets without incurring prohibitive transaction costs. For example, there must be a free flow of information facilitating arbitragers' exploitation of profit opportunities. If information is not forthcoming, economic agents will not be aware of the profit opportunities and, hence, will not be in a position to take advantage of them. Oftentimes, information is not perfect in that the extent of profit opportunities is not certain, *ex ante*, to the arbitragers. In this case, a risk premium would be included as part of the transaction costs, and if this inclusion does not render the costs prohibitively high, efficient movement across markets of the goods will occur. In this regard, it is useful for market infrastructures such as futures and forward markets to be in place so as to abate risk and, hence, reduce the required premium for undertaking the risk. There are other elements of market infrastructures that are important. For example, transportation infrastructure should be present if the market is to function in an inter-regionally efficient manner. Likewise, storage infrastructure is essential for inter-temporal efficiency and processing infrastructure for inter-product-form efficiency.

Market infrastructures in Latin American countries are, in general, insufficient, and infrastructure investments tend to be biased against small farmers. Poor rural regions are often the last regions to get investment in infrastructure and, consequently, markets in those areas tend to be very poorly developed (IFPRI). It is important that the distortion be removed to allow

small farmers to compete on a level playing field so that they have a real chance of lifting themselves out of poverty. In urban areas, many wholesale markets are old and poorly maintained, and do not have sufficient food storage facilities. As to the retail markets, while contemporary supermarkets tend to cater to only the needs of higher-income families, the informal retailing sector for the poor often lacks appropriate health and safety regulations. Policies should promote competition and sound regulations to ensure food safety. Overall, transportation, storage, processing, distribution, and communication infrastructures must be improved to better link production areas and consumer markets, to reduce per unit costs of food and improve food access and availability, and to facilitate information flow on market demand and prices so as to promote competition.

The second condition that must exist before the market can function in an efficient manner is the assurance of an environment in which no individual market participant can have the power of unduly affecting market outcomes such as prices and quantities. Traditionally, the market power concerns have been focused primarily on issues surrounding monopoly and oligopoly (and their variations), and anti-trust regulations have been used (with various degrees of success) to reign in the power of big players. More recently, the industrialization of livestock production, particularly around large cities in middle-income countries, has become an emerging concern. The livestock industry in some part of the region is becoming increasingly vertically integrated with production, processing, distribution, and even retailing sub-components of the food chain business being linked in a very self-contained, highly coordinated manner. The integration enables firms to heighten production efficiency, improve quality control (both inputs and outputs), and enhance information flow within the food system. A vertically integrated

livestock production system also serves as a mechanism by which upstream smallholders can receive financial, technical, marketing and other supports from their much larger, better organized, downstream counterparts, thus, in effect, circumventing some of the previously mentioned infrastructure biases against smallholders in poor rural areas. However, the industrialization may threaten the livelihood of independent small producers who are not able to or choose not to become part of the vertical chain for either philosophical or practical reasons. Policy makers should encourage small-scale producers, who are handicapped by higher post-farm marketing and processing costs, pursue options for reducing costs and promoting market opportunities. For example, there may be a role for the government to facilitate the formation of producer groups of independent smallholders to countervail the market power of integrated units and to negotiate for more favorable prices and marketing arrangements.

While there are many other preconditions essential to market efficiency, we conclude the section with a brief discussion on the inappropriateness of governments using price systems in agricultural factor and product markets to accomplish their social goals (or, more precisely, their political agenda). It is generally agreed that market efficiency improves and marketing costs fall when the government no longer manipulates the market and distorts prices. Explicit or implicit food subsidies through the price system tend to benefit the rich more than the rural poor and, hence, are detrimental to the growth of rural economies. Rather, support to small farmers should be more effectively achieved by decoupled instruments such as direct income transfers which do not distort price signals. While governments should not distort factor and product prices, competent public administration and investment in public goods remain essential to assure that market contracts are enforced, grading and quality control standards are maintained, and safety nets are provided for vulnerable groups (IFPRI).

Summary and Conclusions

The extent to which Latin America can pull itself out of persistent poverty in the foreseeable future depends, in an important manner, on how successful the region will be in growing its rural economies and in what way the gains will be distributed to the rural poor. Growth can not be sustainable unless the gains are distributed equitably. A good strategy for sustainable growth in rural Latin America is to make sure that the market works for the poor. Key markets important to the development of the region's rural economies include labor markets, financial markets, land markets, and agricultural factor and product markets. Due to their intricate interrelatedness, piece-meal single-market reforms may not yield the intended results. For example, a well-intended land reform without the necessary accompanying reforms in the rural financial market may prove to be only futile. While governments should continue their refrains of not intervening directly with the market and distorting price signals, they can play a very positive role in facilitating market reforms and in ensuring that the rural poor indeed emerge as winners. This is particularly the case in the provision of goods and services where markets fail and in the promotion and regulation of free and competitive market environments.

An overarching priority in the development of Latin America's rural economy should be the building of rural infrastructures pertaining to the well-functioning of key markets mentioned above. This infrastructure building requires the participation of all players in the "greater community" including not only the region's private sector and its local and national governments, but also the international aid agencies, research institutions, as well as governments and consumers of the well-off nations. To achieve the vision of poverty eradication and economic equity, the "greater community" should work together to adhere to the recent reforms based on sound economic reasoning and responsible social concerns, and resist

the temptation of falling back to the old track of extensive government market interventions and overly inward-looking development strategies. The temptation is great, given the economic and political hardships that some of the countries in the region are currently experiencing. However, for the sake of the region's rural poor, it is high time for the "greater community" to take up its historical challenge and boldly go to the place where no community has gone before.

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