

**From Equity to Prosperity:  
On the Precarious Growth-Record in Mexico**

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Two hundred and fifty years ago Adam Smith wrote that “Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things”.<sup>1</sup> Such a succinct summary of the foundations of prosperity constitutes a reasonable framework to understand the obstacles faced by Mexico and other Latin American societies to start a process of sustained growth. This is especially so if one looks at the implications that persistent inequality might have on the the *Smithian* pillars described above.

There is a vast literature on the determinants of economic growth. Such literature includes the analysis of institutional aspects on growth dynamics, though with a relatively weak empirical basis. In general, as it has been argued elsewhere, the poor growth-record of several countries in the Latin American region can be explained by looking at three aspects, namely: endowments, institutions, and policies. In principle, among those three aspects, only the first one –endowments— is truly exogenous, while the other two are subject to different sorts of rigidities and inefficiency traps, which feed back on each other. In this note, inequality and economic polarization are suggested to have a fundamental importance in obstructing policies and individual behavior that is growth-friendly.

There are at least three channels through which economic inequality may indirectly obstruct growth: i) inequity fosters potential conflict, and the latter has an impact on transaction costs and contract enforcement, ii) it reduces the overall competitiveness of the economy, as in the *O-ring* theory of economic development, and iii) it makes fiscal policy more ineffective and inefficient, both from the

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<sup>1</sup> Adam Smith, *Lectures on Jurisprudence*, 1755.

income and from the expenditure front. I shall hereby present a conceptual basis for this hypothesis, as well as some indicators that may constitute evidence in such direction from the recent evolution of the Mexican economy.

### **Channel 1: Inequity fosters potential conflict, with and impact on transaction costs and contract enforcement**

Putting together elements of the new development economics literature, it is hereby claimed that low-growth traps are determined to a large extent by massive coordination failures. Moreover, weak institutions fail to coordinate expectations and are thus unable to induce an individual behavior that is consistent with Pareto-superior outcomes.<sup>2</sup> The latter explanation assumes that key economic and social interactions imply strategic complementarity that lead to multiple equilibria. Examples of such interactions have been analyzed in the literature in relation to industrialization, corruption, labor markets, and migration, among others.<sup>3</sup> In all cases, interactions with multiple equilibria, which can be Pareto-ranked, require credible coordination devices to move the economy to welfare improving scenarios. As opposed to prisoner's dilemma type of situations, in this case once-and-for-all interventions can have permanent effects. Coordination, however, is thwarted by a lack of social cohesion, fueled by high levels of inequality and social polarization. In this setting, inequality and polarization acquire pragmatic importance by becoming obstacles for institutional credibility and by fostering higher levels of potential conflict, threatening what Smith would call a peaceful environment. The latter increases transactions costs and obstructs efficient contract enforcement. Recent literature has shown the both inequality and polarization have an effect on crime. Andalón and López-Calva (2002) show that petit crime and homicide related to it is correlated with polarization using data for the main urban areas in Mexico (Table 1). Lopez-Calva (2004) also shows a robust correlation of such indicators with other forms of social conflict, like strikes, blocking of roads, and others. Such evidence goes in the direction of the effects hereby stated. Literature for other

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<sup>2</sup> Ray, D. (2000).

<sup>3</sup> Murphy, et al. (1986), Tirole (1996), Basu and Van (1998), López-Calva (2002), Adserá and Ray (1998), among others.

countries in Africa and even the United States have also proved that private contributions for investment in public goods are negatively correlated with ethnic and social polarization. We may thus state that it makes sense to talk about inequality-driven underdevelopment traps. Coordination devices like norms, common beliefs and the respect of the law may be weakened in their effects by a lack of social cohesion and what the polarization literature calls “alienation”. Higher levels of *bonding* social capital do not necessarily imply more cohesion if *bridging* social capital is missing.

### **Channel 2: Inequity reduces the overall competitiveness, *a la O-ring***

Following the idea developed in Kremer (1998), it can be argued that inequality, among individuals and regions, reduces aggregate competitiveness. Not only is it the case the inequality among individuals in terms of human capital, abilities and access to public services, reduce overall productivity and competitiveness, but also inequality across regions. The latter diverts resources and increases transport costs. Already Temple and Johnson (1998) have shown that indexes of inequality of social development –which include access to basic infrastructure--constructed in the early 1960s have considerable predictive power for economic growth in after the 1960s. Quality has to be standardized for all inputs, regardless of the individual or region that provides them, in order for the economy to be competitive overall. For Mexico, one example is Dávila, et al. (2002) that clearly establishes how the South Eastern part of Mexico has lagged behind the rest of the economy after trade liberalization due to considerably higher transport costs and lower human capital basis. Maps 1 through 4 below show the magnitude of social regional inequality in Mexico using Human Development Indicators by State. Esquivel, et al. (2003) show that between 1950 and 2000 there has been a process of convergence in Human Development, process that slows down after the structural reforms in the 1990s. Moreover, if one looks at convergence for each component of the Index, gaps in health and education continue to narrow, while income starts to diverge after 1980. By 2000, the gap between the highest and the lowest achievement in health was around 10%, in

education has above 20% and the same indicator for income was above 50% (UNDP, 2002). If one moves to the municipality level, using infant mortality as an indicator, the most developed municipality in Mexico has a level similar to Western Europe, while the least developed municipality can be compared to Sub-Saharan Africa.

### **Channel 3: Inequity makes fiscal policy more ineffective, from both the income and from the expenditure side**

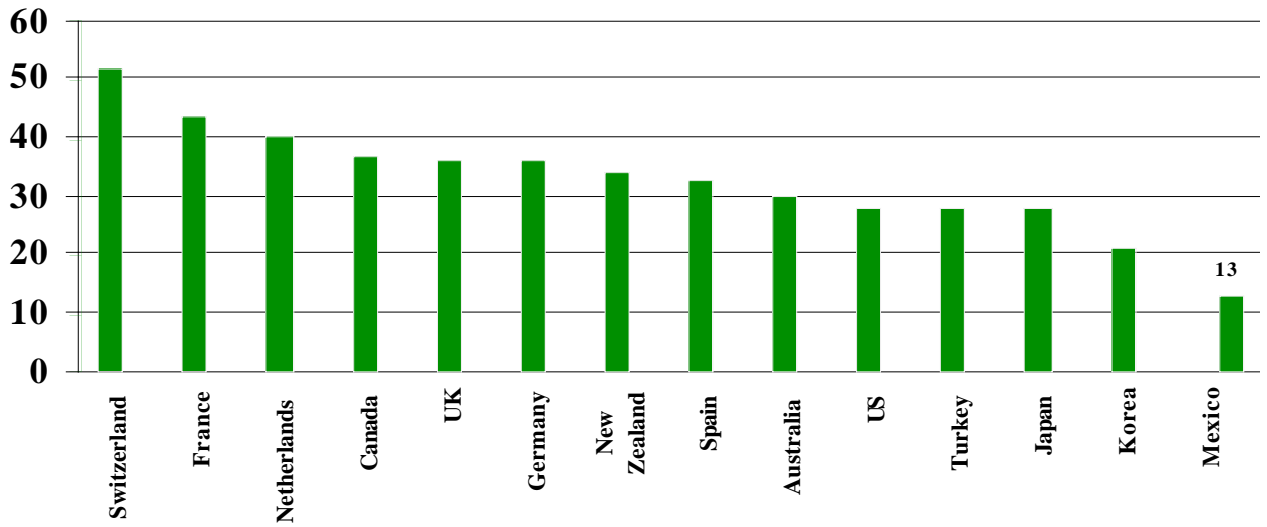
Initial inequality has been shown to have a negative effect on tax-collection, cost-effectiveness of pro-poor policies, and determines to a great extent the progressivity of specific fiscal expenditure schemes. The “easy taxes” component of the *Smithian* pillars is thus harmed by an unequal distribution of income. Moreover, a more polarized distribution –a bimodal distribution coming from taking mass from the middle class to the extremes—also polarizes the political discourse and makes it harder to reach agreements, especially in the realm of fiscal reform.

Mexico collects about 13% of GDP through taxes, though the figure goes down to less than 10% if taxes coming from oil exports are eliminated (graph 1). That weakens the State and narrows the room for active policies. There is no chance to build a successful market economy without a strong State. The progressivity of social expenditure has increased since the 1990s in Mexico, though year by year more progressive programs face the threat of cancellation by Congress, a Congress whereby urban middle classes are overrepresented. To mention one example, the Program of Temporary Employment (PET), a program designed to act in a countercyclical way to provide income to poor people in depressed areas, has been eliminated for the 2005 budget, after a short life of only six years. Fiscal policies, both through income and through expenditure, become more inefficient and ineffective. Political agreements become harder. Growth is thus thwarted.

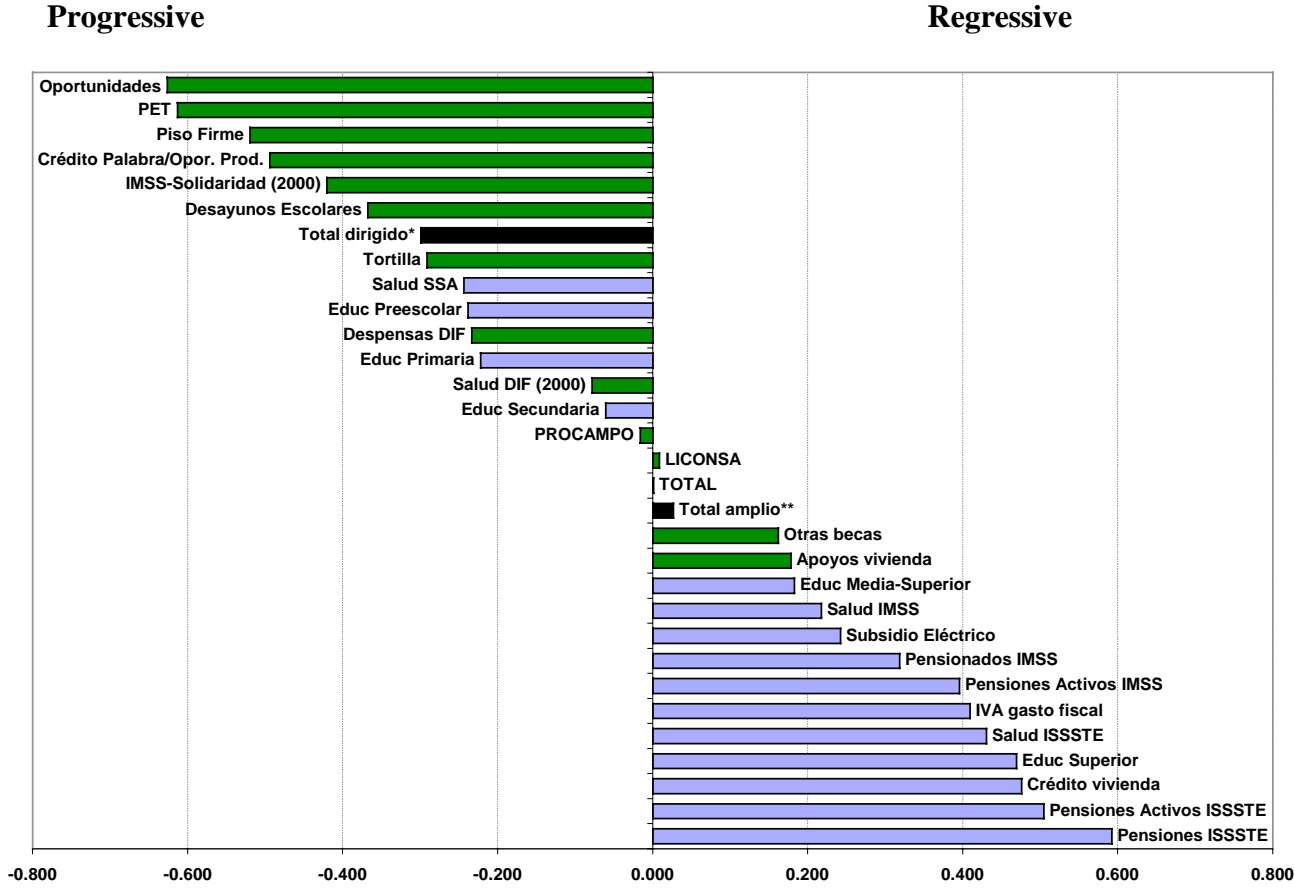


**Graph 1: Tax Collection as % of GDP**

**Tax-collection in OECD Countries**

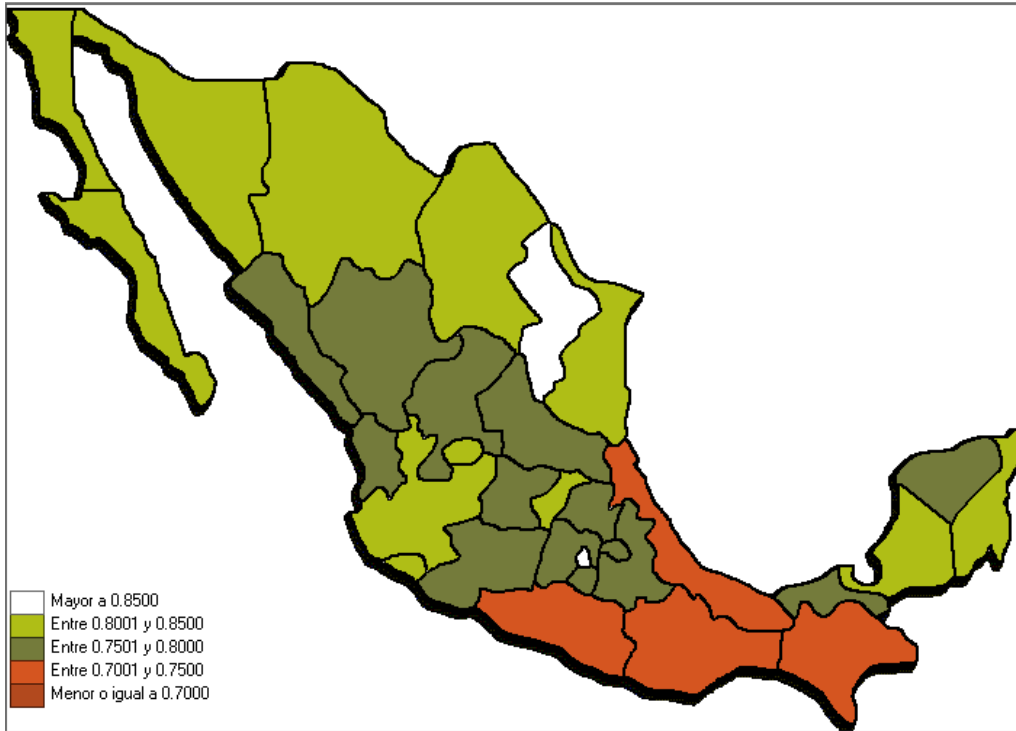


**Graph 2: Progressivity of Social Programs**

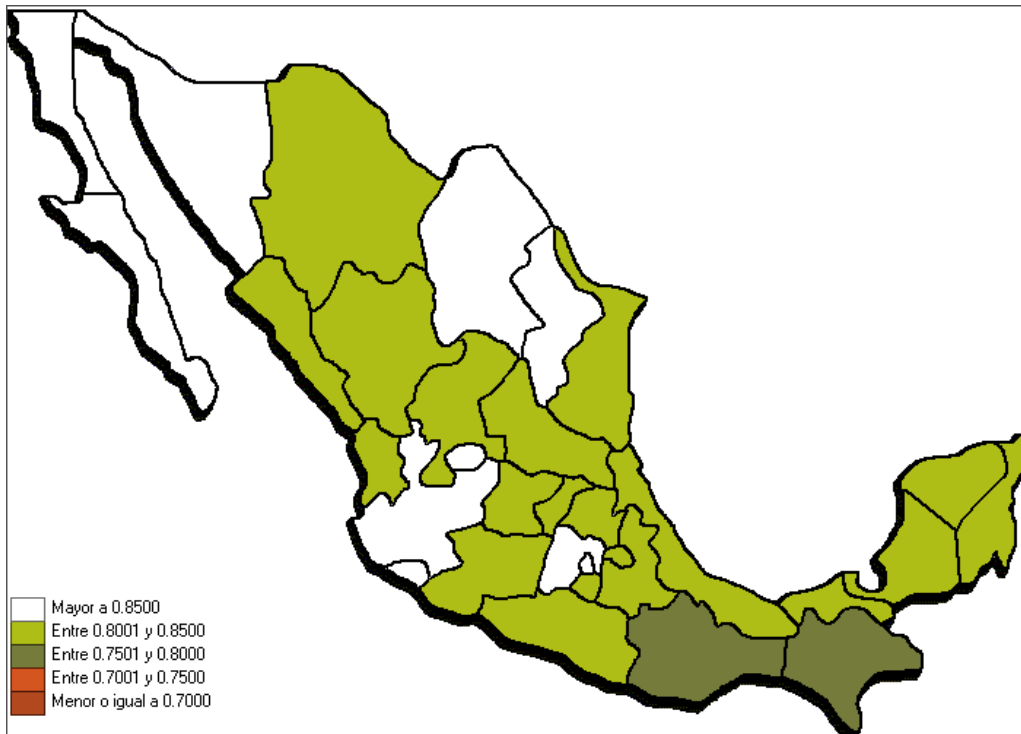


Source: Scott (2004)

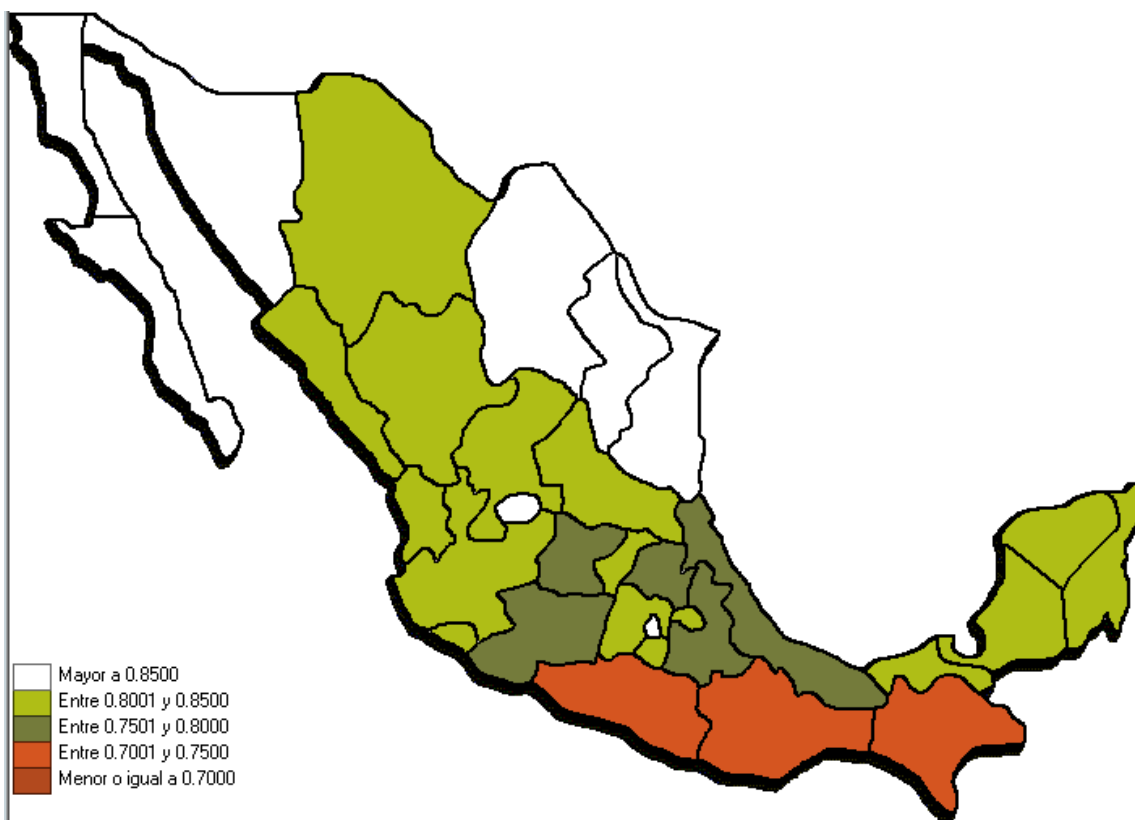
**Map 1: HDI in Mexico, by State**



**Map 2: Health Index in Mexico, by State**



**Map 3: Education Index in Mexico, by State**



**Map 4: Income Index in Mexico, by State**

