Center for Global Development

CGD Brief

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Growing Pains in Latin America:

An Economic Growth Framework as Applied to Brazil, Costa Rica, Colombia, Mexico, and Peru*

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Before the global economic crisis began in 2008, all countries in Latin America, long known as the world's most economically and financially volatile region, had experienced five consecutive years of economic growth, a feat that had not been achieved since the 1970s. Yet despite this growth, Latin America's income-per-capita gap relative to high-income countries and other emerging-market economies widened, and poverty remained stubbornly high. Latin America, in short, suffered from growing pains even when things were going reasonably well.

What policies could help Latin America avoid these pains and achieve accelerated, sustained growth that reduces poverty and inequality? To find out, CGD senior fellow Liliana Rojas-Suarez convened a task force to identify the foundations of growth in the region.[1] Prominent experts in Latin America were then invited to apply this framework to five very different countries by assessing past reform efforts and offering practical suggestions for the future. The task-force framework and the subsequent case studies form the book *Growing Pains in Latin America: An Economic Growth Framework as Applied to Brazil, Colombia, Costa Rica, Mexico and Peru.*

An Economic Growth Framework for Latin American

The framework identifies the key foundations for growth in Latin America and provides a mechanism for designing reforms that strengthen these foundations while taking into account the region's unique characteristics and obstacles to market-based reforms and sustainable growth.

The unique features of Latin America

While Latin America shares many features with the rest of the developing world, and countries within Latin America differ significantly among themselves, three features characterize most countries in the region: Latin America is the most financially open, the most democratic, and the most socially unequal of the world's developing regions.

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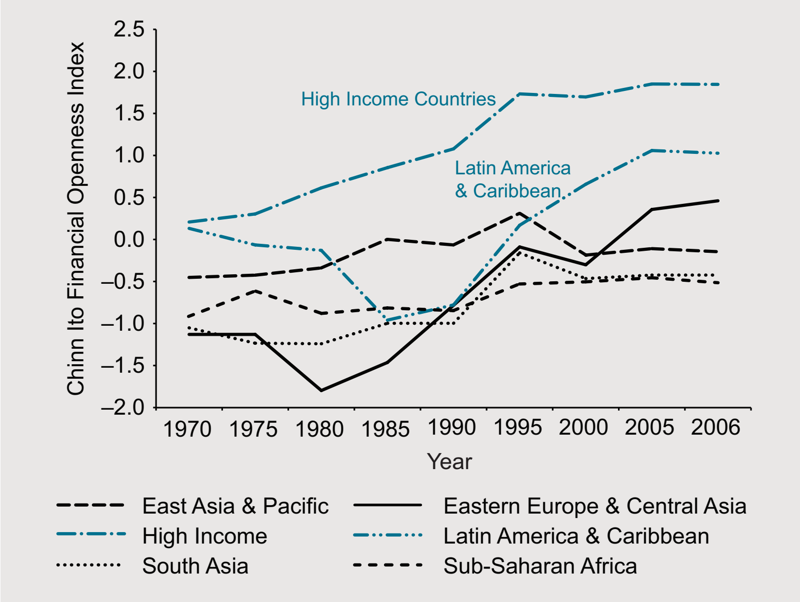
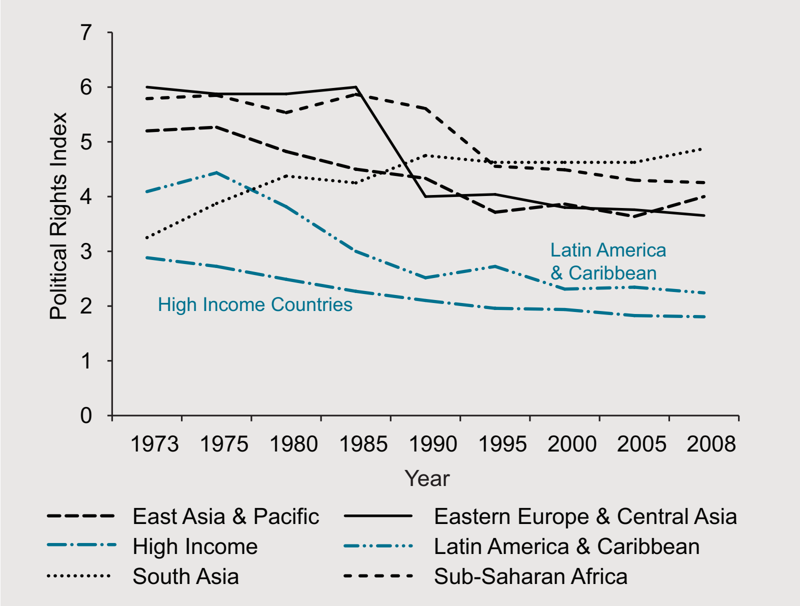
1. The CGD Task Force was chaired by Liliana Rojas-Suarez and Simon Johnson. The task-force members were Mauricio Cárdenas, Javier Corrales, José de Gregorio, Augusto de la Torre, Eduardo Lora, Carmen Pagés, Kurt Weyland, and Jeromin Zettelmeyer.

Figure 1. Financial openess



Source: Chinn and Ito (2007).

Figure 2. Democracy



Source: Freedom House.

Latin America's financial openness, which began with the securitization of government debt under the Brady Plan in the late 1980s,[2] has increased both its financing capacity and its vulnerability to changes in investors' perceptions of a country's creditworthiness. The preference in most Latin American countries for a liberalized capital account means that macroeconomic indicators must be stable at all times, since any deviation will quickly increase the perception of risk, causing capital inflows to reverse and interest-rate spreads to widen, to the detriment of investment and growth. A successful framework for growth must account for these facts.

By several measures, Latin America is the most democratic region of the developing world. Latin America's democratization, on the rise since the 1970s, is due largely to the decline of military regimes. Like financial openness, the region's level of democracy must influence any framework for growth; some reforms, for example, might not be sustainable if a significant proportion of voters do not share in the benefits. Also, any backlash against market-based reforms can be expressed through democratic processes and undermine the chances of further reform.

Skepticism about reforms is a consequence of the region's high inequality. Latin America has persistently had one of the most unequal income distributions since the 1960s, even exceeding that of sub-Saharan Africa in 2005. Evidence suggests that income inequality over a certain level is likely to reduce growth, in general, and stymie the reform process in Latin America, in particular.[3]

2. The Brady Plan was implemented in 1989 in response to the developing-country debt crises of the 1980s. The Brady Plan provided debt relief, contingent upon economic reform, and allowed countries to issue highly tradable securitized debt.

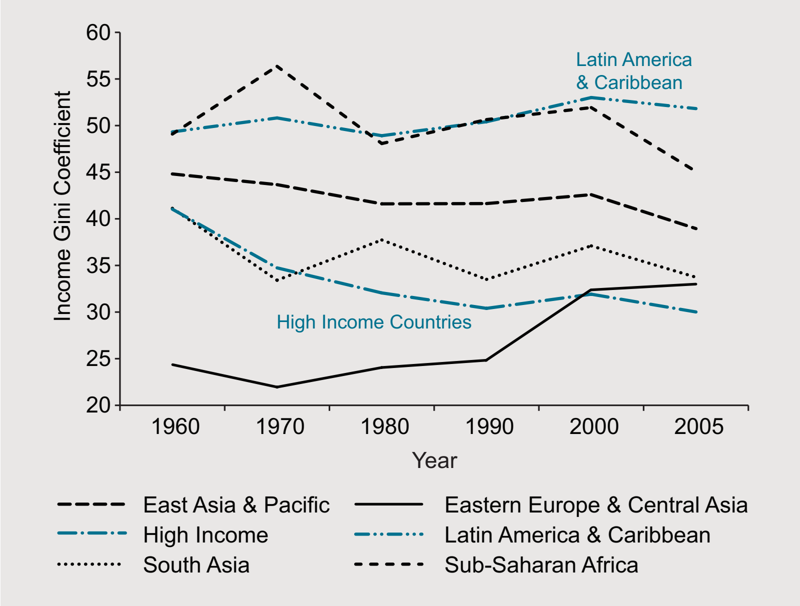
3. Nancy Birdsall, "Income Distribution: Effects on Growth and Development," CGD Working Paper 118 (Center for Global Development, 2007).

The five foundations for growth

The high degree of financial openness in Latin America allows market forces, through the behavior of the international capital markets, to assess the performance of its economies. The first basic foundations are therefore those that create incentives for the appropriate functioning of markets in all market-based economies:

1. *Secure property rights* for the majority of the population, so that individuals and firms can benefit from their investments
2. *Sufficiently equal opportunities* for broad segments of society, so that individuals and firms without political connections or great wealth can enter the market
3. *Sufficient economic and political competition,* to avoid capture of the state by powerful elites

Figure 3. Income Inequality



Source: Rojas-Suarez (2009), *Growing Pains in Latin America*, based on data from WIDER WIID2a and WDI–WB.

In Latin America, the combination of the region's high financial openness, limited trade openness, underdeveloped local financial markets, and low national savings rates leads to the fourth foundation for growth:

4. *Macroeconomic stability,* to avoid recessions and fiscal adjustments that generally lead to cuts in social expenditure and infrastructure spending. In contrast to industrial countries, a slight departure from macroeconomic stability in many Latin American countries quickly leads to a deterioration in investors' confidence in policymakers' capacity to deal with the problems effectively and promptly

The fifth foundation reflects the need to reconcile market-based reform with the discontent that large segments of the population have with the market system:

5. *Broad sharing of the benefits from growth,* to ensure that market-based reforms and policies conducive to growth are sustainable

The framework: making the foundations for growth work

What sets this framework apart from others is its incorporation of the three distinguishing features of Latin America: its greater financial openness, its greater democracy, and its greater inequality.[4] Table 1 (next page) lists several of the main areas of reform and indicates which of the foundations for growth each area of reform has the *potential* to affect. (This is a summary assessment derived from a review of the literature on the effects of individual reforms on growth. It should be taken to be illustrative, not representative of every case and circumstance.)

4. While the framework as designed to be specific to Latin America, it has much in common with other important contributions to the literature on the search for "foundations for economic growth." See, for example, Ricardo Hausmann, Dani Rodrik, and Andrés Velasco, "Growth Diagnostics" (John F. Kennedy School of Government, Harvard University, 2005) and Commission on Growth and Development, *The Growth Report: Strategies for Sustained Growth and Inclusive Development* (World Bank, 2008). In Nancy Birdsall, Augusto de la Torre, and Rachel Menezes, *Fair Growth: Economic Policies for Latin America's Poor and Middle-Income Majority* (Center for Global Development and Inter-American Dialogue, 2008), the authors present a toolkit for policymakers to achieve growth on an equitable basis.

Table 1. Potential Impact of Selected Reforms on the Foundations for Growth

Reform	Property rights	Equal opportunity	Competition	Macroeconomic stability	Broad sharing of growth benefits
Trade		✓	✓✓	?	?
Financial	✓	✓	✓	✓✓	✓
Labor	✓	✓✓			✓
Pension	✓	✓✓		✓✓	?
Privatization with regulation[a]	✓	✓		✓	✓
Budgetary institutions		✓	✓	✓✓	✓
Education[b]		✓		✓	✓✓
Fiscal Decentralization	?	?			✓✓
Tax reform	?	✓	✓	✓	✓
Judiciary	✓✓	✓	✓	✓	✓
Electoral process		✓	✓	✓	✓
Legislative	✓	✓	✓	✓	✓
Anti-corruption	✓	✓	✓	✓	✓

Note: One checkmark indicates a positive potential impact of the indicated reform on the indicated foundation, two checkmarks a strong positive impact, a question mark an uncertain or mixed impact, and a blank cell no impact.
a. The table illustrates the potential impact of telecommunications privatization; privatization of other state enterprises might have somewhat different impacts.
b. Reform of other social services (for example, health care) would likely have similar impacts.

The main conclusion from the literature is that well-designed and adequately implemented reforms in a variety of areas can indeed contribute to sustainable growth. In practice, however, past reforms have not always lived up to their potential to strengthen the five growth foundations.

Obstacles to growth in Latin America: the framework applied to Brazil, Colombia, Costa Rica, Mexico, and Peru

Obstacles can either prevent reforms from being enacted in the first place or dull the effect of enacted reforms. When implemented reforms fail to realize their potential, the failure can generally be attributed to one or more of three possible problems: problems of relevance (the country is not ready for the reform or particular features of the country render the reform undesirable), problems of design (incomplete or poor implementation, misaligned incentives), and problems due to local conditions (such as inequality, adverse political dynamics, insufficient implementation capacity, or a deep vulnerability to external shocks).

Once the constraints and obstacles to reform have been identified, the question then becomes what to do about them. This is the core of the case study analyses, each authored by a different group of experts.

Case studies of Brazil, Colombia, Costa Rica, Mexico, and Peru first apply the framework for growth to assess past and current reforms and then make recommendations for future reform efforts. Each case study emphasizes policy recommendations that are both economically and politically feasible.

Brazil

ARMANDO CASTELAR PINHEIRO, REGIS BONELLI, AND SAMUEL DE ABREU PESSÔA

Brazil implemented many economic reforms in the decades after the resumption of civilian rule in the 1980s. The reforms targeted the *economic and political competition* and *macroeconomic stability* foundations, but the overall effort was disorganized: some were oriented toward enhancing the role of the market and some toward strengthening the state. The reform process led to a large increase in public spending, which the government attempted to finance first through inflation, then through issuing debt, and finally through tax increases.

Today, *macroeconomic stability* is the most crucial missing foundation, closely followed by *secure property rights*, due to the current system of high public expenditure. To enhance stability, Castelar Pinheiro, Bonelli, and Pessôa suggest reforming fiscal policies to reduce public consumption and tax policies to decrease the current tax burden. They recommend reforming the judiciary to strengthen *property rights*, which have been weakened by past judicial reforms that increased the independence of the judiciary. In Brazil's judicial system, contracts are constantly breached and rulings delayed by politically motivated judges. The authors propose, among other actions, using performance indicators rather than seniority as the basis for judicial promotions, indexing judicially imposed obligations and debt to the policy interest rate (best known as the SELIC) to reduce the financial incentives of delaying final court rulings, and raising public awareness of the consequences of poor judicial performance for economic development and social equity.

Colombia

ROBERTO STEINER, IRENE CLAVIJO, AND NATALIA SALAZAR

In 1990, Colombia embarked on a comprehensive reform program, but the initial drive for reform failed to deliver on many of its promises, and some reforms actually weakened foundations for growth. After 1999, however, the reform agenda was reinvigorated, and many of the initial design problems were addressed. This process, coupled with a benign external environment and a much-improved security situation, produced economic growth and sparked a renewed decline in poverty. But additional reforms were still needed to make growth sustainable and more inclusive, and the current international financial crisis has stalled any post-1999 progress. To get Colombia back on track, Steiner, Clavijo, and Salazar suggest addressing weaknesses in *economic and political competition, equal opportunities,* and the *broad sharing of the benefits from growth*, for which they recommend tax reform, deepening of the financial sector, political and labor-market reforms, and political and fiscal decentralization.

They also recommend three judicial reforms to curtail the excessive judicial activism in the Constitutional Court, which interferes with economic matters in general and with *macroeconomic stability* in particular.

First, lessen the politicization of court magistrates by allowing them to run for a second term, after a cool-off period of perhaps five years. Under the current system, magistrates may not be reelected, but they face practically no restrictions on their involvement elsewhere in politics after their tenure.

Second, seek a consensus definition of what constitutes adequate health care and other social services so that judges cannot decree the provision of services beyond the agreed-upon plans.

Finally, have the Constitutional Court review laws as soon as they are approved, so that any overturning on procedural grounds would occur before the law takes effect.

Costa Rica

JORGE CORNICK AND ALBERTO TREJOS

Despite Costa Rica's mostly positive economic-policy performance since the 1980s crisis, economic reform has lately become increasingly difficult. Three factors seem to account for this: worsening income distribution, which has robbed the political and economic system of some of its legitimacy; public-sector reform which was simplistically confused with mere downsizing; and political events that have reshaped the ideological and party structure, leading to congressional atrophy and paralysis. Since the mid-1990s, the emergence of a new political opposition has created a multiparty congress with little ground for consensus.

Congressional rules that used to work adequately in a two-party system have proved ineffective and have allowed strong minority opposition to paralyze further reform.

In such circumstances, strengthening the *broad sharing of the benefits of growth* is especially important to lessen opposition to reform. Cornick and Trejos recommend setting a deadline by which the congress must vote on proposed laws; granting the executive limited power to declare certain bills urgent to expedite congressional deliberation; creating alternative ways for representatives to put their positions forward, place them on the record, and propose amendments without the long delays that characterize current procedures; and requiring a quorum only for votes, not for debate. The authors stress the advantages of referenda which specify a fixed date for votes, preclude the possibility of filibusters, and create binding results widely viewed as legitimate. Other suggestions include reforming taxes to boost state revenue, which would benefit all growth foundations, especially *macroeconomic stability,* and liberalizing trade, especially in the telecommunications industry, to lower barriers to entry, thereby strengthening *competition* and providing more *equal opportunity*.

Mexico

GERARDO ESQUIVEL AND FAUSTO HERNÁNDEZ-TRILLO

Since the late 1990s, perceptions of past failures and an increasingly complex political environment have led to inaction and fatigue in Mexico's approach to reform. Some needed reforms face substantial ideological opposition, but others could be achieved in the short run with support from the congressional majority. Esquivel and Hernández-Trillo concentrate on this second group of reforms to target all five growth foundations.

First, legal and judicial reforms would improve the enforcement of *property rights* and increase *equal opportunity* and *macroeconomic stability* by reducing the cost of access to the judicial system and the legal and administrative cost of enforcing tax laws and discouraging tax evasion.

Second, reforms on competition policies would remedy the inadequate regulatory and supervisory framework. Such reforms are highly dependent on legal and judicial reforms. For example, although a law was passed in 2006 enhancing the powers of the Federal Competition Commission (FCC), the judicial and legal systems continue to be major obstacles to economic competition. Decisions by the FCC can be delayed for prolonged periods through a number of judicial protection mechanisms. In addition to improvements in the judicial system, specific recommendations to heighten competition include providing full autonomy for the FCC and creating specialized courts in competition and regulatory cases (similar to Chile's Tribunal for the Defense of Free Competition).

Finally, reforms to open, deepen, and enhance competition in the financial sector would improve the *broad sharing of the benefits from growth*, *equal opportunities,* and *economic competition* foundations.

Peru

EDUARDO MORÓN, JUAN FRANCISCO CASTRO, AND CYNTHIA SANBORN

Even during the boom of the mid-2000s, economic growth in Peru was not very inclusive. Although Peru has had periods of fast growth compared to the rest of the region, none has lasted long enough to significantly reduce poverty and inequality. In the past twenty years, social and economic inequalities have worsened, fueling discontent and leading to calls for radical change. While the recent positive economic growth (of more than six consecutive years) has reduced poverty and income inequality on a national basis, urban-rural disparities are widening. Thus, the *broad sharing of the benefits from growth* is the foundation most in need of strengthening in Peru. Morón, Castro, and Sanborn identify three areas of reform that would address this foundation:

- First, public administration reform to improve implementation capacity (see below for more details)
- Second, education reform to improve the quality of basic education through performance evaluations and the equality of access to higher education through an expansion of higher education credits for poor households
- Finally, political reform to strengthen Peru's weak and fragmented party system, which upsets the foundations for inclusive growth

Deep reforms of the state and the political system are essential to pass legislation and execute policies that will reach the poor, especially in the country's rural areas. The current lack of implementation capacity—reflected in a shortage of professional civil servants—constrains fiscal and political decentralization, which in turn delays and even blocks much-needed infrastructure and social-service projects. Introducing a merit-based career path for new public servants, programming budgetary expansions in a results-based format, and consolidating small geographic units into fewer, larger ones would all help Peru get programs off the ground. In the face of managerial constraints, it would be easier to distribute public resources and monitor their utilization if the 25 existing regions were consolidated into seven to ten regional governments. Creating a pilot macroregion could demonstrate the potential benefits of consolidation.

Conclusion

Effective design and implementation of economic growth reforms in Latin America must take into account the particular features of the region and the specific economic, social, and political characteristics of individual countries. Latin America is in the unique position of being the most financially open, the most democratic, and the most unequal of all regions in the developing world. These features define and constrain the policy environment, determining which policies and reforms can effectively deliver sustainable growth.

The reforms proposed for individual countries paint an optimistic picture because the proposals are practical and doable. Reforms must be incremental and be implemented through consensus rather than by imposition. Indeed, while the necessary reforms vary significantly across countries, the need for increased dialogue between governments and civil societies is common throughout.

The potential for successful market-based reform in Latin America is real, but policymakers must act quickly and be alert to regional and country-specific challenges. The current financial crisis has only served to amplify the need for policies that are able to provide sustained, rapid growth that benefits a broad share of the population. While the crisis has put the brakes on the impressive growth achieved by Latin America in the last five years, the right approach should be

Further Reading

Nancy Birdsall, Augusto de la Torre, and Rachel Menezes. 2008. *Fair Growth: Economic Policies for Latin America's Poor and Middle-Income Majority*. Washington, D.C.: Center for Global Development and Inter-American Dialogue. http://www.cgdev.org/content/publications/detail/15192

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Commission on Growth and Development. 2008. *The Growth Report: Strategies for Sustained Growth and Inclusive Development.* Washington D.C.: The World Bank. http://www.growthcommission.org

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