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“The Way Forward in Latin America¹”

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In terms of economic progress, many Latin American countries have turned in disappointing results ever since the start of the debt crisis in 1982. The question, however, is how to remedy this poor economic performance without jeopardizing the area in which the region has by most people’s standards made historic progress since 1982: establishing democracy.

There is a small but fairly robust econometric literature on the relationship between democracy and growth (e.g. Barro 1996, Helliwell 1994, Svensson 1999, Tavares and Wacziarg 2001). There is little evidence that democracy has much impact on growth overall; some channels are favorable (e.g. income distribution, political stability),

¹ Outline of remarks at the session “Democracy and Reform in Latin America: How to Build More Competitive Economies,” Competitiveness and Democracy Task Force, Center for Hemispheric Policy, University of Miami, Coral Gables, December 4, 2006. Copyright Peterson Institute for International Economics: All rights reserved.

some (e.g. via the level of investment) are unfavorable, but overall the effect is at best modest. The net effect of democracy on growth may be slightly negative, but this is not an effect that is definite or powerful enough to change the mind of anyone who believes in the value of democracy for its own sake. In contrast, there is very strong evidence to believe in a positive relationship going from growth to democracy. As people become richer, one of the things they want is a say in how they are governed. Non-democratic countries that are becoming richer are very likely to confront a problem at some stage, but this is a problem for China rather than Latin America.

In some respects differences within Latin America are sharper today than ever before, at least post World War II. There is the oft-remarked contrast between the modernizing socialism of Chile's Michelle Bachelet and Brazil's Luiz Inácio Lula da Silva as against the old-fashioned populist socialism of Venezuela's Hugo Chávez and Bolivia's Evo Morales. The impact on Latin American countries of the main international event of our day, the emergence of China onto the world stage, is profoundly different for the South American countries that stand to benefit because they export many raw materials, and the Central American countries that overwhelmingly export manufactures and therefore face the daunting prospect of having to compete with China. Despite those differences, there are important commonalities — or at least near-commonalities — with regard to both democracy and growth.

So far as democracy is concerned, the longstanding exception is Cuba. Every other country in the hemisphere remains a democracy in the basic sense of the term. Admittedly this is a very basic sense, defined as a system in which a majority of the population could change the government if they were so minded without risking their necks in the process. Many other attributes of good governance are sometimes included under the heading of democracy, but to my mind clarity is aided if we stick to basic definitions such as the one offered. There is also a single exception (in this case, Chile) to the proposition that growth remains a problem.

What, then, would be needed to achieve rates of growth (of at least 5 or 6 percent per year) that are now considered respectable for a developing country? There is no single simple remedy for low growth. If socialism or any other “ism” offered a panacea, it would have been adopted long ago. Reality is complex, and the fact that this is increasingly widely recognized is progress. In *After the Washington Consensus: Restarting Growth and Reform in Latin America*, a recent book that I co-edited (Kuczynski and Williamson 2003), we concluded that the needed policy measures could be summarized under four headings:

1. **Crisis-Proofing.** A series of crises led to the lost half-decade (1998-2002), so policies needed to be adjusted to minimize the chances that the region would again be laid low by crises.
2. **Completing First-Generation Reforms.** We did not apologize for the Washington Consensus—or, for that matter, endorse all the reforms that supposedly “augment” it, like capital-account convertibility and bipolar exchange rate regimes. But we recognized how incomplete modernizing, market reforms

- are, and urged that countries persevere with this agenda rather than again be lured by doctrines such as Socialism that have conclusively failed in the past.
3. **Implementing Second-Generation Reforms** (by which term is meant institutional reform). Just which institutions most need attention varies dramatically between countries, but all countries have urgent needs in terms of some institutions.
 4. **Income Distribution and the Social Agenda.** We argued that policy should not just aim at accelerating growth, but also that it matters profoundly *who* benefits from growth. Latin America being the most unequal region of the world, there is ample scope for policies to improve income distribution without impeding growth.

Many Latin American countries have made good use of the current prosperity to address the first of these needs. External debts have been cut drastically, exchange-rate policies are less brittle and therefore less likely to lead to crises, fiscal deficits are lower, current accounts are mostly in surplus, and much borrowing is taking place in domestic rather than foreign currency. Individual countries may still go into crisis when the price of an important export product falls, but the danger of a new regional crisis appears minimal. The one indicator that has not shown much improvement yet is the ratio of public debt (including domestic debt) to GDP, and until this happens countries will have to remain cautious and will be unable to implement radically expansionary policies if a new recession hits. Despite this, my view is that macro issues no longer constitute the main Latin American problem.

Much more serious to my mind is the continuing slow growth and failure to achieve a major equalization of the distribution of income. The remaining parts of the Kuczynski/Williamson agenda outlined above were addressed to increasing the supply-side rate of growth and distributing its fruits more equitably. A number of other writers in this series have addressed issues that can be fitted naturally into the preceding Kuczynski/Williamson taxonomy, and perhaps the most useful thing that I can do is to comment on a number of their suggestions.

One issue that has been raised is the age-old one of whether societies should seek to use primarily the market or the state to decide questions of what is produced and what techniques are used to produce it. The evidence suggests that Latin Americans tend to be suspicious of the market and happy to assign a big role to the state. This is shown by popular opposition to more privatization, and the inordinate difficulty in many Latin American countries in establishing new firms (in the formal sector) or trading across borders or employing workers. This is not a set of attitudes supportive of rapid development. Growth is promoted by individuals seeing the prospect of personal gain by setting up their own firms or selling on a world market or expanding the employment they offer. Asia has many such individuals and it grows, Latin America has too few.

A particular aspect of suspicion of the market is the hankering after industrial policy. There is no serious evidence that industrial policy was responsible for the success of East Asia; it is true that some economies adopted industrial policies, but others (like

Hong Kong) did not, and it seems odd to attribute the success of a group of countries to what they did *not* have in common. Quantitative evidence suggests that the benefits of fiscal policy and budget subsidies in Japan and South Korea went primarily to declining natural resource sectors, not to the emergent leading industrial sectors that the folklore of industrial policy asserts to have been the primary beneficiaries. If one wishes to give a leg up to innovative industrial sectors, then a much more promising strategy is the adoption of national innovation systems as advocated by the Organization for Economic Co-Operation and Development (OECD), in which the firms that benefit self-select as those wishing to innovate in contrast to those chosen by some well-meaning bureaucrat as particularly likely to be “winners”.

I would argue that another false solution is the yearning for strong intellectual property rights. No one denies that these have the advantage of enabling firms to profit by innovating, and that innovation is highly desirable. But they do this by prohibiting other firms copying useful inventions (at least for many years), and thereby they impede the spread of knowledge. We need to weigh the benefit to innovating firms at the frontier against the cost to firms that would otherwise be able to catch up with the frontier much more rapidly, rather than taking it for granted that any benefit to the former represents a net social gain. Analysis says that countries not yet close to the intellectual frontier are unlikely to benefit themselves by legislating property rights stronger than those their international obligations compel them to abide by.

Most Latin American countries penalize their formal firms by requiring them to abide by a set of labor standards that are at best appropriate only for advanced countries and at worst make firing prohibitively costly. Despite strong econometric evidence, it is rarely recognized that restrictions on firing have such a damaging effect on hiring that they lead to a net reduction in the supply of jobs in the formal sector. The problem of large numbers of workers being forced into the informal sector is unlikely to be solved without a major liberalization of the labor market. To say this is not to imagine that politicians are about to implement such a liberalization, but progress will never happen unless those in a position to advocate change speak of its benefits.

Many Latin American countries could give a boost to their economies by reforming their fiscal systems. The problem (except in Brazil) is not an excessive level of taxation; it is excessive complexity of taxation obligations, so that determining how much tax to pay is too much of a burden on enterprises². Neither is the problem that taxes are excessively progressive; the primary beneficiaries of loopholes are those rich enough to afford tax accountants, so that tax simplification could be designed to increase progressivity as well as tax yields. Tax reforms should aim to simplify taxation obligations, to broaden tax bases by closing loopholes so as to increase progressivity, and — where taxes are presently too low — to raise more revenue so as to permit greater government spending without undermining fiscal discipline.

² The World Bank compiles statistics of the time taken to fulfill corporate tax obligations. Of the seven regions into which it divides the world, Latin American firms require the longest time. (In contrast, their tax *burden* is close to the median.) See <http://www.doingbusiness.org/ExploreTopics/PayingTaxes/>.

Finally, let me say that I endorse wholeheartedly two solutions that have been called for by many other participants in this series: better education and more spending on infrastructure. The world of tomorrow is one in which the well-educated will be those who are well-paid—and benefit their fellow-citizens the most. And the world of tomorrow will not arrive without a modern infrastructure.

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