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SOME IDEAS ABOUT A NEW POLICY CONSENSUS FOR LATIN AMERICA

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Resumen

Este ensayo, escrito originalmente en 2002 y revisado a comienzos de 2003, parte de la constatación que los gobiernos elegidos democráticamente en Sudamérica en la última década, han prometido una agenda de cambios, para luego aplicar políticas económicas ortodoxas, para luego indagar en posibles explicaciones. Entre ellas se releva el rol del pragmatismo, que ha desplazado al tradicional voluntarismo de las élites políticas de la región, en parte por la constatación de los límites objetivos a los márgenes de maniobra que se enfrentan hoy, y en parte también a la menor tolerancia de los electores al desorden económico. El trabajo concluye explorando opciones para ampliar dichos márgenes de maniobra, respetando las restricciones que impone la disponibilidad de recursos.

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SOME IDEAS ABOUT A NEW POLICY CONSENSUS FOR LATIN AMERICA

Joaquín Vial[1]

INTRODUCTION

Anyone familiar with Latin American countries will recognize the symptoms: Discredited politicians, no confidence in the judiciary, or almost any state institution for that matter…, deep resentment with the perceived unfairness of the economic system, skepticism about the future and frustration with the current economic situation, and so on. Latin America, in general, is not a happy place these days. The traditional problems have not been solved and the Age of Instant Communication makes evident everyday and to every family, that the gap with richer societies is growing. For many, the best hopes for a better and safer future lie in emigration to the U.S. or Europe. The visions of Latin America as a "paradise found" and a "land of opportunity" have been replaced in our imagination by that of a "paradise raped and spoiled" and a "land of unchanging inequality".

After the collapse of the "Imports Substitution Model" in the 70's, the demise of socialism and central planning in the 80's and early 90's, and the frustration with the lack of tangible progress after the "Washington Consensus" reforms of the 90's many claim for a new paradigm to orient development strategies in the region. In fact most governments recently elected in the region, have come to power with promises of "change"… but, with the exception of Venezuela, all of them have implemented market-friendly policies, stuck to fiscal austerity and named well-prepared and quite orthodox economists to key positions in their economic teams. And they have done this right from the start… Does this means that populism in Latin America has been replaced by deception and cynicism? Is it that no alternative exists? Or perhaps - as I want to argue - is it the case that a new policy consensus is painfully and slowly being built? This new

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consensus seems to be based on the hard-acquired awareness of the need to respect macroeconomic constraints[2]. Given those constraints, it then comes the realization that these countries have far less room for social, political and economic experimentation than we thought we had, back in the seventies and eighties.

However, it is very clear that pressure for some form of policy "change" in the region is growing. The risk is that pressure might force some countries to abandon sound practices and policies learned at great national sacrifice in favor of some form of populism. But in stress there is also opportunity, and we are seeing now that in some countries that pressure is pushing governments to take action in areas traditionally considered "out of bounds". It is very important for the future of the region that the opportunity for positive change be seized now. Most of the countries in the region will not be able to do so acting on the basis of their own resources alone, and they will need help in this process from other governments and multilateral organizations, but there is little doubt that the impulse for change must come from the countries themselves. The path of recent events show that time is running out and action should start now.

Some background

When we hear current opinion leaders – politicians and economists as well – refer to the supposedly dead "Washington Consensus" (WC), very often we get the impression that the WC was a product of an isolated brainstorming session by a group of economists and Washington bureaucrats. In fact we tend to forget that the WC was the result of a collective learning process after all major Latin American economies collapsed during the Debt Crisis. It basically reflected the lessons learned from that collapse and the subsequent adjustment processes, and as such it had very precise historical roots: it was the reaction to the acute macroeconomic disequilibria and general economic mismanagement left by the "Age of Voluntarism" in economic policy-making in Latin America in the 60's and 70's.

[2] For a similar point of view, see S. Edwards op-ed in the Financial Times published in July 2002.

"Voluntarism" means in this context that governments acted as if they could promote growth with massive investments in infrastructure and productive enterprises; that inflation could be kept in check with price and exchange rate controls; that capital could be made available cheap to the private sector; that governments could secure permanent jobs at decent salaries for everyone; that public expenditures could be funded by charging higher tax rates affecting a dwindling minority of citizens. This vision was shared by socialist governments and right wing military dictators; by the Church and marxist leaders; business bosses and union leaders alike. No wonder hyperinflation, foreign exchange crisis, budget deficits and massive accumulation of debt affected so many and diverse countries in the 70's and 80's[3].

As I see it, the WC was not meant to become a "development paradigm", but was a set of reasonable policy proposals that seemed feasible after the realization that "Voluntarism" was not a viable alternative. Then, fiscal austerity, market prices, privatization, respect for monetary policy autonomy, trade liberalization set in as necessary conditions to be respected in order to achieve the elusive macroeconomic stability and perhaps economic growth.

Political systems also collapsed under the weight of the economic crisis, and military dictatorships - the norm in the early 80's - were replaced by democratically elected regimes all over the region. One by one countries in the region began adopting economic reforms to correct the mistakes of "Voluntarism". Some did it earlier: their crisis came earlier and their policy responses helped shape the WC: Chile and Bolivia come to mind, as well as some of the earlier "liberalization cum stabilization" attempts in the Southern Cone. The 90's started with great promise: freedom and democracy flourished in the region, there was a clear agenda of economic reform with great promise. There was even a useful example: Chile made those reforms in the 70's and 80's and was enjoying unprecedented stability and growth. Political leaders as diverse as Fujimori and

[3] The economics roots and consequences of populism – a close relative to voluntarism – in Latin America have been very well documented in Dornbusch and Edwards (1991).

Menem were elected to fight the "Chicago-IMF model" and met great economic and political success by switching horses, becoming champions of pro-market reforms.

For some time things improved significantly: inflation was brought under control all across South America for the first time in the second half of the 20th Century, and some countries managed to achieve impressive rates of growth – 7 or 8% a year – for a couple of years. Wall Street analysts, Washington and the IMF were very quick to proclaim success and could find no fault with the economic policies – and sometimes with the dubious political practices – of the newly reformed countries. Capital markets opened up and money flowed unrestricted into these countries. Overvaluation of some currencies was not seen as a major problem: reforms were bound to generate productivity gains large enough to compensate overvaluation. There were signs that not everything was going well, growth petered out, budget deficits were not eliminated but transitorily financed through privatization, financial markets operations were predominantly short-term, interest rates were high and the memories of past inflation induced many countries to opt for dollar indexed financial operations as a way to develop their domestic financial markets.

The confidence crisis that followed the Tequila episode in 1995 induced significant improvements in the operation of financial systems everywhere, and international banks began taking over major local banks. Many saw these changes as a positive sign: weak lenders of last resort in the countries were replaced by rich international mega-banks that could come to the rescue – with dollars – if something came wrong. However, economic growth slowed down across the region and came to a halt in 1998 when the Asian Crisis caused capital flows into emerging markets to dry up. A few countries devalued their currencies to facilitate the adjustment - Brazil, Chile, Colombia, Bolivia, to some extent – but several ones could not afford that luxury: a fixed nominal exchange rate to the dollar was an essential condition for the preservation of the local financial market and for political stability. Weak international export prices, capital flows reversals and worsening fiscal balances translated into recession in almost all the countries in the region. Colombia experienced the first case of negative income growth after the Great Depression, and even Chile – the regional showcase of a successful reform in the second half of the 80's and 90's – fell into recession in 1999.

One bright spot at the time was the upsurge of Foreign Direct Investment, caused mostly by mergers and acquisitions of private sector utilities, banks and a decreasing number of privatizations. But even that began to dry up too after 2000, when Spanish banks began losing their initial enthusiasm for the region, and the international financial community began to worry about impending financial crisis in Argentina, Brazil and – more recently – Venezuela. The initial optimism of the early 90's did not survive the decade: the period of growth was far too short to make a significant difference for most countries.

Two major exceptions emerge in this bleak picture: Chile and Mexico. Even though economic growth has fallen drastically in Chile since the late nineties, the economy does not present major imbalances, has maintained full access to international financial markets at low costs and is beginning to recover. This is the only country in the region that has been able to sustain expansionary fiscal and monetary policies during this period without falling into unsustainable dynamics and maintaining a very good stance in international financial markets. Mexico opted in the 90's for full integration with the US economy and reaped spectacular gains thanks to this decision after the "Tequila Crisis" in 1995. The Asian Crisis and the Argentine collapse did not affect Mexico so much, but of course they were severely affected by the downturn of their gigantic northern partner in 2001. A difficult political transition towards a normal democratic system has not helped either and the economy has slowed down somewhat in the last couple of years, but it is still grounded on a solid basis.

Elsewhere in the region the countries are in trouble: some because of the large public debt inherited from the 1980's, aggravated by unsolved fiscal problems in the 90's (Brazil, Argentina), in others is the "fear of floating" and credit crunches due to currency mismatches in the private sector and the pullout of capital from the financial sector – the Argentine crisis dispelled the illusions of foreign banks acting as lenders of last resort –

and others suffering from some vernacular tragedies: exploding violence in Colombia, populism in Venezuela, political unrest in Paraguay, indigenous upheaval in Bolivia and Ecuador, etc.

The sad reality is that reform has not translated into a significant rise in living standards, or hopes for higher economic growth for most of the region. Unemployment has been on the rise and many have given up on any hope for these countries. Long queues in the major airports in most of the Andean countries and Argentina are an eloquent testimony of this collective frustration. One sad benefit of this state of despair is the fact that remittances from nationals working abroad have become major contributors to the foreign exchange earnings of countries like Ecuador, Colombia, Bolivia, and could even happen in Argentina[4]. Some might argue that the reforms came too late or were too partial. Even if that is true, it is clear that the appetite for reform is exhausted and many are looking for alternatives.

Why Fox, Lagos, Toledo, Uribe, Lula and Gutiérrez persist in economic orthodoxy?

Given the circumstances, it is no wonder that almost every president elected after 2000 has been chosen on the basis of promises of "change". Of course, Fox and Uribe had far more pressing agendas for change in the political and security arenas to also promote changes in the economic systems, so it is not surprising that they have stuck to economic orthodoxy. But all the others were quite explicit in their presidential campaigns about the need for change in economic conditions and even, in some cases, in the basis that inspired previous economic policies and reforms[5].

The fact of the matter is that the crisis of the 70's and 80's have thought a lesson to Latin American politicians: economies are more complex now than before, they are more integrated into the world economy and as long the countries need access to fresh

[4]Mexico, Central America and some countries in the Caribbean, like the Dominican Republic already went through this process in the 80's and 90's.

[5] This is truer for Lula and Gutiérrez than for Lagos and Toledo. The latter were far more cautious during their campaigns and insisted in introducing corrections while keeping the basis of the economic system intact.

foreign capital to keep functioning – not mentioning the need to finance economic growth -, they have no room to violate some basic financial constraints. Even worse: the watchdogs in Wall Street do not even allow for the freedom to appear as they might violate those constraints. Even large – and quite closed – Brazil realized that during the excruciatingly long months of the presidential campaign of 2002.

Once they have realized that their vulnerabilities make impossible to depart from fiscal and monetary orthodoxy, some of these governments are beginning to find that they still have significant room for action, as long as they are able to tap local resources to address their key priorities: President Uribe in Colombia had a mandate to improve security, but no money to back it up. In other times he might have been tempted to print money to build up a credible army and worry later about inflation… However he choose to tax the rich – a long overdue change in the region – to finance the armed forces build up, and he got the votes in Congress to push that reform through. Lula and Gutiérrez have made strong commitments in the fiscal front, and are eliminating inefficient subsidies to the rich and the middle class, re-allocating funds to attend key priorities and campaign promises, like the eradication of hunger in Brazil. Lagos is pushing through Congress an ambitious health reform, and increasing some taxes to pay for it…

What we are seeing is not inaction, or cynicism, but positive action to pursue agendas for change, within the limits of the financial constraints the countries face. The international environment is not helping, the world economy remains in the doldrums gripped by the fears of war, capital flows remain at minimum levels. However, we can see now a slow recovery of confidence and in some countries capital is not flowing in, but at least stopped flowing out. In fact, initial actions by the governments in Brazil and Ecuador have been well received everywhere.

Perhaps Latin American leaders have finally realized that are limits to what governments can achieve, and now see that the political costs of economic chaos are far too high to take too many liberties with the budget or with Central Bank's printing presses. However some of them are reaching the limits of the people's endurance and patience is running out in many places. It is clear that fiscal and monetary orthodoxy are needed to keep the economies running, but that surely does not secure growth. It is also clear that without economic growth, there is no hope to reduce the abysmal gaps between rich and poor, or at least in the opportunities their children face.

This is probably why there is so much talk now of the need of new paradigms and development strategies. However, this is a chorus with many voices: the loudest are of those who argue that "they knew that orthodoxy was doomed" and are claiming for a complete revamping of the economic system, even going back to exchange, credit and price controls, protecting the domestic economy and using the fiscal sector to inject new life to domestic demand and economic activity. After years of marginalization and quasi-oblivion these circles have gained some room in the public debate in most countries, but are still in the fringes of the political system, with the only exception of Venezuela.

Is President Chávez's revolution the beginning of the end or the end of the beginning?

Many have hailed President Chávez's election and subsequent "Bolivarian revolution" as the beginning of the collapse of the economic model based in the Washington Consensus. Later elections of seemingly heterodox presidents in Brazil and Ecuador, as well as strong showings by candidates "from the outside" in Bolivia, Peru and possibly in Argentina are usually cited as evidence of the imminent demise of the market based reforms and the economic policies that marked the nineties. But this might be an oversimplification: even though left-leaning presidents have been elected in many countries in the last few years, all of them have been quick to take distance from Chávez's revolution and have not followed in his steps.

The reason is simple: President Chávez had by far the best opportunity to break away from traditional orthodoxy and resist any external pressure to do so: the lowest external debt in the region, huge international reserves, an extremely favorable price of oil, uncontested popularity and a strong mandate for change. Still, he blew his opportunity: the economy has been in a free fall since 2002, inflation is on the rise and the economic downturn has evolved into a major political crisis. He has shown to anyone interested in learning from his experience that even those unmatched conditions could not prevent a quick deterioration of the domestic economy. After just a couple of years is policies have taken the economy into the road of upheaval and economic disaster. Even before the recent national strikes, prominent economists were joking that he had finally achieved the long-dreamed de-coupling of the Venezuelan economy from the oil price: in 2002 Venezuela's GDP fell by about 7% while oil prices reached record highs!

President Chávez's experiment might very well be the last expression of the old fashioned voluntarism, and the warning signal that prevented Lula, Gutiérrez and perhaps even the future president of Argentina, whoever might be, to return to the disastrous practices of the past.

Is there something new brewing in the region?

There are other critical voices, besides those of the "old guard", claiming that the reforms of the nineties are not enough to achieve sustained growth and some measure of economic justice. Sometimes they come from government circles themselves – more through policy actions than by systematic discourse –, academic circles (Stiglitz, 2002, Rodrik, 2001, Sachs and Vial, 2002) and surprisingly enough, they also appear in public statements, books and policy recommendations from multilateral organizations like the World Bank, IDB, CAF and even the IMF. They are pointing towards specific areas of policy change, going far beyond the original Washington Consensus. In what follows I will try to identify some of these ideas. In my view, they are quickly becoming the basis of a loose, but emerging consensus geared towards achieving sustained growth and poverty alleviation, perhaps even with some hope of reducing income inequalities in the long term.

1. **Macroeconomics: from short-term stabilization to medium-term sustainability:** the main focus of the WC was to bring to the attention of policy-

makers and opinion leaders the need to live within the limits imposed by financial constraints. However, that has proven insufficient for two reasons: hard-to-manage initial conditions and high vulnerability to commodity price shocks and capital flows reversals. On the initial conditions: Most of the Latin American economies inherited high public debts – domestic, foreign or both – as a consequence of pre-82 imbalances. Macroeconomic adjustments and the taming of runaway inflation restored access to capital markets and the appreciation of domestic currencies masked the rise of government obligations, but they did not restore fundamental fiscal solvency. In fact, the international community has recognized that, agreeing to debt-relief programs (HIPC I and II) that have proven insufficient in scope and coverage: Debt overhangs affect not only the poorest countries, but also some middle income countries, and the extent of debt relief has been clearly insufficient, as proven by the experience of Bolivia. In addition to that, they remained chronically vulnerable to commodity price shocks. The worsening international scenario has shown that short-term macroeconomic stabilization might prove unfeasible if those vulnerabilities are not reduced. In fact, since 1998 almost all the economies in the region were forced to jack-up interest rates at some moment, to avoid major exchange crisis, and fiscal policies have been heavily pro-cyclical almost everywhere, reducing expenses and raising taxes at times when the economies were falling into recession, just because there was no way for them to finance the deficits. A major exception to this trend has been Chile, the only country that systematically reduced public debt during the 90's, implemented successfully a copper stabilization fund accumulating government savings in periods of high copper prices, and tried to keep domestic demand in check during the heady days of glory of emerging markets. The implementation of a "structural budget deficit" policy-rule in 2000, supported by more than a decade of positive fiscal outcomes, has allowed this country to follow a – moderate – counter-cyclical policy in the latest years. Interestingly enough, international financial markets have been able to discriminate among countries and fiscal virtue has been rewarded: Chilean risk premium has remained very close to that of medium level U.S. firms.

This experience has attracted a lot of attention (see Perry, 2002, for instance) and several countries are trying to move in this direction by passing legislation to enhance "fiscal responsibility" and introduce some fiscal rules, sometimes with mixed or very poor results. One important element to bring into the discussion is the role of processes and institutions, as well as political will, for the formulation of fiscal policies, as stressed by Alesina and others (Alesina et al., 1996; Schick, 2002). However, all these efforts might prove futile if the countries try to apply these rules starting with unsustainable high levels of public debt from the onset.

The main corollary of this might well be that countries will have to find a way to bring down the absolute size of the public debt as quickly as possible as a pre-condition to achieve sustained growth in the medium term. This seems unthinkable in today's political environment. A major change in attitude is needed to get the process started and this will require major help from the international community, not only to the poor countries, but also to countries like Argentina. The IMF will have to shift the focus of its stabilization programs from short-term financing to truly medium-term solvency restoration. A pre-condition for this help must be legal action to mobilize internal resources to restore fiscal solvency, perhaps with a combination of higher taxes (applied over time) and privatization. Political leaders will probably have to pick up the discourse of "re-gaining economic autonomy and independence" to justify those measures to reduce public debt, and that will probably have to be accompanied by IMF cum globalization–bashing rethoric to make it politically feasible.

2. **Social policies: from interference in market processes to taxes and transfers:** During most part of modern history, Latin American countries have relied heavily in price controls, labor market regulations, and other legal and administrative actions to try to force more justice and equality into the economic system. Scarce fiscal resources were used to promote industrialization and secure the support of politically-emerging social groups giving away generous transfers, mostly through the pension system and salary increases to public employees. The traditional

system of taxing the rich to finance direct transfers to the poor was implemented only partially and in fact, taxes have fallen dis-proportionally in the middle classes and most of the transfers have also landed in those same middle classes. Fiscal adjustments of the 80's and 90's have reduced some of those transfers, and in some cases taxes have been raised, while at the same time governments were trying to target transfers to the poor. No wonder why there is so much anger in traditional "emerging" groups against economic reforms. Interference with the price system was abandoned in most of the region in the 80's, when it became evident their ineffectiveness to bring inflation down. Privatization of parts of the Social Security System also reduced significantly government transfers to middle classes, if not immediately, at least in the long term, and "Solidarity bonds" and other direct transfers to the poor have become a familiar component of any adjustment program. More recently, the attention given to the idea of "competitiveness" has also brought to the forefront of the discussion the social costs of excessive protection to the – formally – employed (Heckman and Pagés, 2000).

These trends seem a positive step forward in order to facilitate employment creation and focus the government effort into direct poverty alleviation, when fiscal resources are scarce, but of course they have greatly contributed to the growing sense of economic insecurity of middle classes (Rodrik, 2001). Some countries are beginning to address this issue by designing alternative mechanisms to provide some income insurance during periods of unemployment (Chile), and many are also trying to improve educational, health and social security services as a way to address those fears. Targeting and focalization of public resources in the poorest is a good thing, but it will not be politically feasible if the institutions to provide some income security and social insurance against unemployment and health for the middle classes are not in place. Since these groups do have some savings capacity, this is not only an issue involving fiscal resources, but also one of building those institutions. This is especially important where financial markets are underdeveloped, focused in short-term operations and where public confidence on the intermediaries or the government is weak.

3. **Education as harbinger of economic progress and integration of the (children of the) poor into the modern economy:** Education has long ago been recognized as a key policy area for development, and there is some evidence of its importance for economic growth (Barro and Lee, 1994), even though the direct linkages between education reforms and economic growth in actual practice have been far weaker than initially expected (Pritchett, 2001). This is an area in which Latin America has lagged behind, both in terms of coverage and quality (Arellano, 2002). Policy efforts have been smaller than in other developing areas of the world, discontinuous, and in many cases the additional resources targeted for reform have been "captured" by teachers' unions, with no significant improvement in their productivity. Public education all over the region remains very much a "government affair", with very little involvement of parents and the local communities and with very little accountability. Rising concerns about the problems to catch up in the use of information and communication technologies is bringing the overall theme of educational reform to the attention of public opinion and policy-makers (when they can take time out from economic and political crisis management). Participation in international testing efforts is also helping to raise awareness and several governments are in the process of design or implementation of educational reforms. There is an emerging consensus that this is also the best hope to facilitate upward economic mobility in the long run, while creating better conditions for economic growth, and that the traditional goals to increase coverage are not enough: hard technical and political choices have to be made and significant fiscal – and private – resources must be mobilized to achieve these goals. Two particular areas of weaknesses seem to be especially hard to tackle: teachers and involvement of local communities. Teachers tend to be poorly educated and trained, salaries have no relationship to performance and their unions tend to be powerful and used to highly centralized wage negotiations with the government. On the other hand, local communities have very little to say

about their schools and parents have very little choice of schools, if any, since there is almost no competition in the system. Again, this is an area in which middle and not-too-low income households can contribute and part of the answer lies in making the necessary institutional arrangements to make that possible.

4. **Institutional reform: one missing link in previous economic reforms:** The WC proposals are a body of policy action recommendations, but they say very little about the institutional requirements to apply them, but for a passing reference to the protection of property rights. There is a mounting body of evidence on the importance of good governance and working institutions for economic growth. Recent efforts to produce, gather and analyze information about this dimension have helped a lot to raise the awareness and understanding about those links (Mauro, 1995, Sachs and Warner, 1995, Kaufmann, Kray and Zoido-Lobatón, 1999). Latin American countries in general perform rather poorly in this area, and that seems to be an important factor explaining their difficulty to attract foreign direct investment in areas other than natural resources and privatization (Vial, 2002, Cornelius et al. 2002), as well as failures in other areas. Awareness on these issues is high, growing and sometimes misguided: blaming politicians' corruption for all the bad things happening has become commonplace in the region, to the point of clouding all other policy issues. Several presidential elections in the last few years have gone to those candidates that projected a better image at fighting corruption, with very little consideration to other issues.

   It is important to recall that most of Latin America has only recently moved to democratic regimes, following long periods of dictatorships and a tradition of political instability. Building effective democratic institutions is not an easy and short process, and there have been major setbacks in the meantime. For instance, several countries have tried to decentralize government action, with rather poor results. In most cases these reforms have led to major fiscal imbalances and/or severe loss of government effectiveness. Judicial reform has been attempted in several countries, but so far there has been no major improvement in people's perception of judiciary effectiveness or independence.

One major challenge will be to incorporate social and ethnic groups traditionally marginalized from the centers of power, something that might prove especially complex for the fragmented and diverse countries in the Andean Region. These groups are now better educated and informed, and have gained access to the media and even into international circles. They come with a long list of grievances and with little experience in government, making the task extremely difficult. Economic distress certainly does not help either.

5. **Innovation and technology acquisition: other missing links for economic progress:** The low ability of Latin American countries to produce native innovation in business and economic activities, and to capture and absorb knowledge and technologies from abroad was masked by the traditionally low levels of competition that characterized the import-substitution period. Concerns for macroeconomic stabilization and the introduction of basic market-oriented reforms kept the issue out of the policy agenda for most of the 80's and 90's and it is just beginning to emerge (Sachs and Vial, 2002, De Ferranti et al., 2002). Some cases of policy activism in Costa Rica and the Dominican Republic, that have been successful in attracting significant amount of Foreign Direct Investment (FDI) into the production of Information Technologies (IT) equipment or labor-intensive manufacturing, have attracted a lot of attention. Almost every country in the region is now pursuing some active policy towards the adoption of IT, with interesting experiences on areas like public education and public access. However, a similar drive on other areas as important as IT for the future development of competitive capacities in these countries is almost inexistent, with only a few exceptions. Brazil has for long followed an active policy in this respect, but it relied too much in protecting the domestic market for "infant industries" to produce a world-class competitive industry, with just a few – and very costly – exceptions (De Ferranti et al., 2002).

Is "competitiveness" the new paradigm for economic development?

One interesting development of the last 4 or 5 years is the emergence of the idea of "competitiveness" as a major inspiration for public policies. Of course this is a very loose concept and could be used to refer to many different things. However, in most places it has two key characteristics that have been very important to shift the focus of public policies beyond traditional short-term crisis management: a) it has an international focus, competitiveness recognizes that there is a world outside and it should be taken as a reference for the design and evaluation of public and private actions; b) it has an strong focus on economic growth, the main motivation to promote competitiveness being the sense that these countries have to find ways to catch up and regain some of the ground lost to the fast growing economies of Asia or Southern Europe (and perhaps even Eastern Europe in a not so distant future).

The international reference is something new to the region and would have been unthinkable at the times of Import Substitution. It is clearly a very positive sign and is helping understand what are the main weaknesses of these economies, as well as the limits of some policies. It has helped focus the attention of business and governments on the "big world out there", with all its opportunities and threats, and has been wonderful to put policy action in an international perspective, both in terms of their justification, as well as for their consequences.

The focus on economic growth in this context is also linked to the development of private sector initiatives in this international context, and the expansion and diversification of exports. It is interesting to note that this was also a main concern of the original "structuralists", but it got lost in the actual implementation of import substitution policies, especially when the notion of "dependence" became a major concern of Latin American elites in the 60's. One of the major concerns now, is that after a decade of economic reforms, these countries still remain very dependent on a few natural resource-based products for their insertion into the global economy. These are usually perceived as pertaining to non-dynamic segments of the global economy and the high price volatility they tend to exhibit is commonly linked to macroeconomic instability.

Can natural resource-rich countries become competitive to export "something else"?

Abundance of natural resources is very good: the countries can earn an income that is well above the productive potential of the "Non-resource" part of the economy. However, this means their labor-intensive products will be priced-out of the market by exports from countries with cheap and abundant labor. This will make their path towards industrialization more difficult, and their insertion in the world economy will tend to specialize in natural resource-based products.

One key question that most Latin American countries will have to address is the impact of their natural resources in their development path. There are several issues involved that merit some comments:

1. **Are natural resources a curse**? There has been controversy on this point, after the works by Sachs and Warner (1995) showed a strong negative correlation between economic performance in the second half of the 20th Century and a large share of natural resources in the export basket of the countries. Some critics have argued that going back in history, there is evidence of successful countries that are rich in natural resources (Scandinavia, Australia and New Zealand, and even the U.S. and Canada), so this should not be considered a curse and they have emphasized the importance of other factors to explain the lackluster performance of the Latin American countries (De Ferranti et al., 2001). The fact of the matter is that there is an issue of opportunity: what worked fine a century ago might not be feasible in today's world, and there is some evidence showing that negative correlations found by Sachs and Warner actually increase when we move closer to the end of the period (Sachs and Vial, 2002). No matter what the past evidence is, the countries that are rich in natural resources should take this as a challenge to find explanations and, more important, the right policy answers to break away from this "curse".

2. **Leamer's hypothesis and economic policies**: Edward Leamer advanced some years ago an interesting hypothesis that might help explain the "curse" and other puzzles (Leamer, 1987; Leamer et al., 1999). It also provides some useful insights on economic policies. He introduced three factors of production in the traditional theory of international trade (labor, capital and a natural resource) to show several things. Two are very important for these countries: those that are labor intensive and natural resource poor will tend to follow a less capital-intensive path towards industrialization, with a gradual increase in wages as capital increases (also gradually). Those that are natural resource intensive will follow a more capital-intensive path towards industrialization, since wages will tend to be relatively higher than in other regions of the world. Two corollaries are especially relevant: a) since natural resource property tends to be more concentrated than labor, natural resource rich countries will tend to have higher income inequality and that inequality will tend to be persistent, since the development path is capital-intensive. b) Capital market failures could stall development in natural resource rich countries, forestalling the capital-intensive industrialization process.

   Several policy conclusions arise from these hypothesis: a) The industrialization path of "China" and "Venezuela" will probably differ, and a middle-income country like Venezuela will find extremely difficult to compete in labor-intensive industries, textiles-type, with the Chinas of the world. b) Lots of attention should be put into the operation of domestic capital and financial markets, as well as in the attraction of FDI to these countries. c) As long as physical capital and human capital are complementary this means that a lot of attention should be put into human capital formation (education, training, re-training, etc.) d) Income distribution policies based in wage and labor market intervention could be very damaging for economic growth and overall employment.

What is truly remarkable about these policies is that they are very different from what most of Latin American countries did during the fifties, sixties, seventies and eighties, so it is no wonder that they have lost so much ground in terms of economic development as compared to other natural resources poor countries like Korea, Taiwan, Singapore or Hong Kong.

Increasing awareness about these issues is a first step. Policies in fact are beginning to line up in this direction. However it should also be clear that these are long processes and results will not be immediate. On the other side, there is still significant room for "one-time" gains in efficiency from market-friendly economic reforms to achieve relatively high rates of economic growth that could be sustained for a few years, while the medium and long term policies described here begin to have some positive effect on the growth performance of these countries.

Tax systems in Latin America: a hole in governments' pockets or the ace-in-the-hole?

It is clear that Latin American countries will not go far if they are not able to achieve high and sustained growth. But in order to be able to address many of the problems we have identified so far, these countries will have to find ways to relax some of the resources constraints they face now. When addressing these constraints it might be worth recalling that most Latin American countries could be easily characterized as "under-savers" who are "under-taxed"[6]. It is no wonder many of them have been accumulating high levels of public debt – especially with the rest of the world – and are facing severe fiscal sustainability problems. It is tempting – and perhaps not so off-the-mark – to call the attention to the remarkable stability of the Colombian economy during the second half of the XXth Century, achieved while that country stuck to fiscal conservatism, and the sad deterioration of that record in the second half of the nineties when the budget position deteriorated sharply; or to the situation of Chile, that has a

[6] See Table 1 for statistical support of this statement. The evidence on "under-taxation" is strong. The one on savings is marginal, however they look clearly too low when we consider that most of these countries rely on the extraction of non-renewable resources to generate a significant fraction of their income. See Vincent (2002) for further discussion on this. Not all countries fit the same description, as shown in Table 2. It is important also to caution against an strict interpretation of "taxation gaps" as should be evident from the values of the R^2 coefficients.

relatively high tax burden when compared to most Latin American countries, and has managed to increase the domestic savings rate and achieve fiscal surpluses for most of the nineties, becoming the most resilient economy of the region to adverse external shocks.

The fiscal sector has been a source of major macroeconomic imbalances in the region, partially because governments have fallen prey to populist trends, but also because the demand for basic public goods in areas like education, health and infrastructure, far strips the ability to raise funds to pay for them. In most cases is not so much that tax rates are too low. In fact in most countries income tax rates are quite high and progressive, but actual tax collection comes mostly from middle-income employees who work in the formal sector, and from indirect taxes. This was already remarked upon in the original "Washington Consensus" list (Williamson, 1990), but very little progress has been made in the meantime, and the efforts to broaden the tax base have not been very effective so far.

Times of crisis are also times of opportunities, and this might be the time for governments to begin taxing more effectively their rich citizens. It is true that capital is mobile and its income is especially hard to tax, but the technologies to do so exist and adjustment programs should place more emphasis on this part of the fiscal adjustment. Of course, this task will be made easier if people's perceptions about the governments' corruption and waste change for the better. If this is the case, this might very well be the case in which additional revenues can be partially allocated to attend key social demands, leaving aside a fraction to help reduce the burden of the debt and improve fiscal sustainability over time.

Increasing taxes in time of distress is not the way to gain friends and popularity, as we have seen recently in Bolivia, neither is privatization, especially when it is proposed without due consideration to local sensitivities, as it happened in Arequipa a few months ago and in Cochabamba a couple of years ago. But when there are not other viable options in the short-run, maybe this is the only way to go. This would require a lot of political capital and coalitions have to be built across the political, geographical and ethnic spectrum in order to address these issues. Failure in this respect will only bring more misery to the people living in these countries.

The international community can certainly help in this process. In the case of the poorest countries like Bolivia, for instance, they can be far more generous in terms of debt forgiveness. Developed countries, and especially the US must also be far more receptive to pleas for trade liberalization and reduction of subsidies in key areas like agriculture: in more than one country these farm subsidies are pushing farmers in Latin America into narcotics production, or putting governments in the impossible situation of punishing their poorest citizens for trying to make a living with the only crop that has easy access to developed markets. Finally, multilateral organizations will have to provide a bridge, because it does not make any economic sense to raise taxes in the midst of a recession. Countries might be able to pass legislation today with gradual increases of taxes taking place over time, and IFIs could do well by helping finance the short-term gaps while the economies recover and new revenues begin to flow into government coffers.

Some final comments

Latin American countries have changed a lot in the last decades. They are now mostly democratic and far more integrated into the World Economy. They have also made great progress in terms of overall economic management and policy design, while struggling with the legacy of weak democracies, ineffective public institutions, neglect and sometimes, active marginalization of social and ethnic groups, and also a poor record of economic performance, high public debts and memories of high inflation. They are now at a crossroads: after implementation of major economic reforms, growth has not come and there is a real danger of major economic and social upheaval in the region, with a serious possibility that some might revert to populism or other policies that offer very little chance for economic progress in today's world.

Political leaders in most of the countries are fighting courageously to maintain key elements of good economic management, but they need to come up with a vision for the future of their countries that can restore confidence in the future. They also have to bring into that vision all the groups that feel excluded from the development process in order to make their democracies viable.

In normal times, with a prospering World Economy, this would be a daunting task. In today's economy is plainly impossible without outside support. Economic orthodoxy will not be able to deliver major long-term relief to these countries if it is not accompanied by a restoration of fiscal solvency, active fiscal policies in favor of the poor, public investments in the construction of social safety nets and in major improvements of the educational and innovation systems, to name just the most pressing requirements. Even though most countries could conceivable be able to tap under-taxed local incomes and/or sell some public enterprises to achieve these goals, this will not happen immediately and will not fulfill their potential, if they are not accompanied by major transfers of resources from the rest of the world and a major reduction of trade barriers to legal exports of these countries.

Failure to address these issues soon, might prove tragic with a significant potential for violence and antagonism towards multilateral organizations, international banks and also the United States. There is still time to act, but it is running out quickly.

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Table 1: Savings and Effective Tax rates in Latin America and the rest of the world

Dependent variable	Intercept	Per capita Income (logs)	Latin America dummy	L. A. and Caribbean dummy	Number of countries	R^2
Savings rate (% of GDP)	-29.87	6.077		-1.987	131	0.332
	(-4.93)	(7.98)		(-.98)		
	-29.46	6.038	-3.363		131	0.339
	(-4.89)	(8.01)	(-1.51)			
Total tax burden (% of GDP)	-18.25	4.947		-3.964	95	0.275
	(-2.61)	(5.75)		(-1.87)		
	-16.79	4.8	-6.791		95	0.314
	(-2.47)	(5.75)	(-2.98)			
Income tax burden (% of GDP)	-8.638	1.917		-1.896	93	0.242
	(-2.82)	(5.08)		(-2.02)		
	-8.04	1.871	-3.671		93	0.316
	(-2.76)	(5.23)	(-3.78)			

T tests between parenthesis

Notes: Dependent variables are averages for the 1985-99 period. Per capita income is for year 1980. The source for all variables is the Global Development Network Growth Database located in The World Bank website (Research Datasets). http://econ.worldbank.org/view.php?topic=18&type=18&id=11949

Table 2: Taxation gaps in Latin America

Country	Actual Tax Burden	Projected Tax Burden (% GDP)	Taxation Gap
Argentina	11.8	25.3	-13.5
Bolivia	10.8	19.7	-8.9
Brazil	17.3	25.4	-8.1
Chile	18.9	22.9	-4.0
Colombia	11.0	21.5	-10.5
Costa Rica	18.7	22.7	-4.0
Dominican Republic	13.2	20.5	-7.3
Ecuador	n.a.	22.0	n.a.
El Salvador	12.4	19.7	-7.3
Guatemala	n.a.	20.9	n.a.
Haiti	10.8	16.5	-5.7
Honduras	n.a.	18.4	n.a.
Mexico	13.6	25.0	-11.4
Nicaragua	22.8	19.3	3.5
Panama	17.8	22.2	-4.4
Paraguay	8.9	20.9	-12.0
Peru	12.6	21.4	-8.8
Uruguay	24.6	24.2	0.4
Venezuela	15.6	26.0	-10.4

Note: Sources: see footnote to Table 1.
Projected Tax burden on the basis of the regression with the Latin America only dummy (setting its value to zero).