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Helping Reforms Deliver Growth in Latin America: A Framework for Analysis

CGD TASK FORCE

Growth in Latin America: The Facts

From at least the early 1950s through the 1970s, much of Latin America experienced a remarkable stretch of relatively rapid economic growth.[1] This growth was impressive but ultimately proved unsustainable. Under the weight of government debt and associated problems, and in the face of a significant adverse global shock, growth declined sharply throughout Latin America in the 1980s. The early 1990s brought recovery, but this was quickly interrupted by the economic and financial crises that plagued the region during the second half of that decade and the early 2000s. From 2004 to 2007, growth rates increased significantly. However, as discussed in chapter 1, in the context of the global financial crisis that started in 2008, many Latin American countries are once again experiencing a serious economic slowdown.

Income per capita is the standard measure of how overall economic performance affects people. Figure 1, taken from Zettelmeyer (2006), traces the logarithm of income per capita in a number of Latin American countries from 1960 to 2005.

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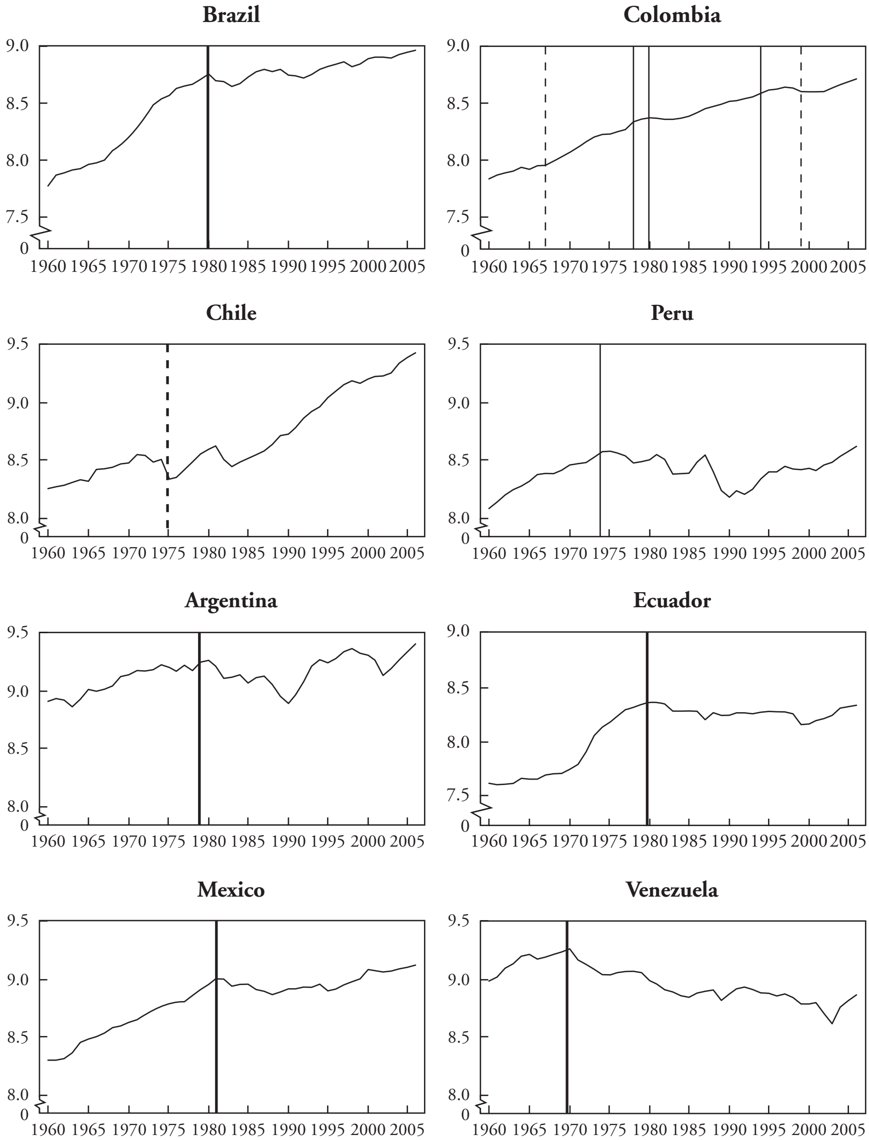
1. The data are less reliable before the 1950s, making it impossible to say exactly when this growth phase began. The 1930s were a period of global depression, which encompassed most of Latin America also. The long growth period likely started sometime in the 1940s.

Figure 1. *Income per Capita and Structural Breaks in Selected Latin American Countries, 1960–2006*[a]

Logarithm of income per capita



Source: Zettelmeyer (2006).

a. Solid vertical lines indicate downward structural breaks in the series, and dashed vertical lines upward breaks, both with a probability $p < 0.10$ (thick lines) or $p < 0.25$ (thin lines).

Dashed vertical lines indicate the beginnings of growth accelerations—periods when growth rates were significantly higher than in the previous period—and solid lines, periods of deceleration.[2] These graphs present a vivid picture, which statistical analysis confirms: although the details vary from country to country, income growth per capita in Latin America clearly accelerated in the 1960s and 1970s and then decelerated in the 1980s and 1990s.[3] It remains to be seen whether a new and statistically significant period of growth acceleration can be identified in some countries in at least some part of the 2000s. As the discussion in chapter 1 indicates, with the exception of Chile (and a slight improvement in the Dominican Republic), the last three decades have seen the gap in income per capita widen in all Latin American countries relative to the most advanced economies.

Of course, decelerations of growth and even outright economic crises are far from uncommon around the world (see Berg et al., 2006, and Jones and Olken, 2005). Recent decades have seen sharp slowdowns of various kinds in places as disparate as the former Soviet bloc and East Asia. In most of these cases one observes, first, a period of confusion and disorganization, often followed by the adoption of reforms that seek to address what are perceived to be the underlying problems—excessive state control of the economy or weak corporate governance, for example. The details of the reform packages vary, of course, according to what is politically feasible or regarded as a priority, but the desire to reform is a nearly universal feature.

Latin America is no exception to this pattern, and the lags observed in the region between the crises of the early 1980s and the attempted reforms of the late 1980s and 1990s were completely within the range of experience elsewhere. But two other characteristics typify most of the reform initiatives in Latin America: economic growth remained volatile after the reforms were implemented, and any gains from growth were not shared by large segments of the population. These continuing problems spurred calls in a number of countries, not for more reform, but rather for the undoing of some of the reforms that had been achieved.[4]

Reform remains controversial in Eastern Europe and East Asia, but in both regions, most countries have found their way onto strong growth paths in the past decade. In contrast, Latin America has seen lower average growth rates and higher volatility of growth than any developing region except Sub-Saharan Africa. It is important not to exaggerate the differences between Latin America and the more successful developing regions, but a gap does appear to be opening up between

2. The solid and dashed lines represent structural breaks in the time series. The procedure used to identify such breaks is performed in stages, one break at a time, and is based on the work of Bai and Perron (1998, 2003); the specifics of the procedure can be found in Berg et al. (2006).

3. However, as Berg et al. (2006) note, the high volatility of output in the region makes it difficult in some countries to identify the decelerations in the 1980s and the accelerations in the 1990s.

4. The important exception is Chile, which launched its reforms even before the regionwide crisis of the 1980s but intensified its efforts soon after.

these regions of similar income per capita and comparable economic potential (see chapter 1).

With so many Latin Americans experiencing such a meager payoff from reform, patience with reform is wearing thin among important social groups. And if reform should falter, the risk is real that Latin America will fall further behind. However, reports of a generalized political backlash against the market economy and market-oriented reform should be taken with caution. As box 1 shows, one of the important differences among countries in Latin America is in the composition of the main political actors. Although a turn toward the left has been seen in some countries, there are nevertheless important differences in ideology and governance between, for example, the current government of Venezuela and that of Uruguay. Meanwhile Chile's government coalition seems, until recently at least, to have been ably accommodating social demands, and the latest elections in Peru are a signal of the urgent need to start incorporating those demands in the political agenda. These are but a few examples of the extent to which the political scene varies dramatically from country to country, whether in terms of the ideological leanings of government leaders, or of the extent to which wide sectors of the population have been included in the debate, or of the main demands being debated.

Where Did All the Reform Go? Factors Breaking the Link between Reform and Growth

The effort at reform in Latin America has been genuine, and it has been long-lived, stretching from the 1980s through the 1990s and continuing into the present decade, although with different timing in different countries. Figure 2 shows how countries have performed in terms of the best available single indicator of structural reform across the region, that of Lora (2001). The index reflects advances in five types of reform: trade, financial, privatization, tax, and labor reform. Although the index leaves out a number of other reforms that have been and are being implemented in many countries—reform of the social sectors and of institutions in particular—it does show that the pace of change was rapid in the 1990s but slowed significantly in the 2000s.[5] As suggested by Lora (2007), reform of the state, in its multiple institutional facets, has been proceeding since the 1980s in a number of countries, but slowly; also, in contrast to the more traditional reforms, reforms of the state have tended to be implemented piecemeal rather than bundled.[6]

5. Lora and Panizza (2002) suggest that the pace of reform was at its most rapid between 1989 and 1994, with Chile again an exception. For an analysis of the early period of reforms, see Edwards (1995).

6. In Lora's (2007) view the unbundling of institutional reforms reflects the attempt of governments to exploit political opportunities for reform whenever they become available, in the expectation that the process would continue.

Box 1. *A Rereading of the Politics of Market Reform in the 2000s: Things Are Not That Bad*

The anti-market forces that have gained political ground across South America since 1998 are far more heterogeneous than meets the eye. Indeed, these forces agglomerate several quite different *varieties of discontent* with the market. Some are clearly inimical to market reform, whereas others represent political demands that could be accommodated by "reforming the reforms" rather than reversing them.

The various leftist movements that have come to power since the late 1990s include, in different proportions, all of the following distinct, but not mutually exclusive, species:

- *Anti-establishment revolutionaries.* This is the old radical left that has never liked the status quo. Their main slogan, "*¡Que se vayan todos!*" became the vox populi during the 1999 constitutional assembly in Venezuela, the 2001 financial crisis in Argentina, and the 2003 crisis in Bolivia.
- *Rent seekers:* These are the old protectionists prominent among business and labor groups, and the patronage-seeking politicians who lost ground with the reforms of the 1990s and are looking for an opportunity to regain control of the state. Their slogan is "Down with globalization and FTAs!" An example is the opposition in 2006–07 in Costa Rica to CAFTA (the Central American Free Trade Agreement), where a popular referendum was needed in late 2007 to ratify the agreement into law.
- *Nationalists:* This group opposed the foreign policy of many Latin American countries, launched in the 1990s, of close realignment with the United States, in the pursuit of free trade and aggressive drug interdiction, and with the International Monetary Fund, because of its perceived micromanagement of national legislation and strict conditionalities. Since 2001, following the 9/11 terrorist attacks and the Argentine financial crisis, both the United States and the IMF appear to these groups—whose slogan is "Down with imperialism!"—to have become far more hard-line.
- *Pro-transparency forces:* These groups wish to see more institutional transparency in the conduct of government affairs: more participation in budget decisions, less corruption, more accountability for decision-makers, better-functioning courts, greater transparency in party and campaign finance, and so on. Their slogan is "Down with corruption!"
- *Pro-access forces:* These groups want more access to the market, through lower prices for privatized services, lower interest rates, and expanded credit opportunities for low-income groups. They advocate dismantling the oligopolies that were created or allowed to survive in the 1990s, making tax systems less onerous on consumers, and expanding the number of well-paying private sector jobs. Their slogan is "Down with inequity!"
- *Big spenders:* These groups want to spend more on old-fashioned progressive policies, such as social services (education and health in particular) and infrastructure and energy development. Their slogan is "We need to invest in our future!"
- *Identity promoters:* The focus of these groups is on ending the system of de facto ethnic apartheid that still prevails in many countries, especially in the Andes, and giving these long-neglected ethnic minorities greater political representation and power. Their slogan is "Multiculturalism starts at home!"

(continued)

Box 1. *A Rereading of the Politics of Market Reform in the 2000s: Things Are Not That Bad (continued)*

The story of the 2000s is one of struggle *among* these various market discontents, at least as much as between them and the pro-market forces. Once in office, leftist leaders have confronted serious internal conflicts among these various forces that got them elected. These different factions have disagreed not just about what to do about markets (the first three groups versus the last four), but also about which other priorities to pursue (the last four groups among themselves).

The main reason for this dissension is that many of these forms of discontent are incompatible with one another. Clearly, the first two groups, and to a lesser extent the third, are the most serious enemies of market reform. But it is not clear that the others are completely adverse to market reform. Rather, they present demands that are more supplementary to than incompatible with market forces. This means that their demands could in principle be met while, simultaneously, market reforms are being pursued—compromise with these groups need not derail the reform agenda.

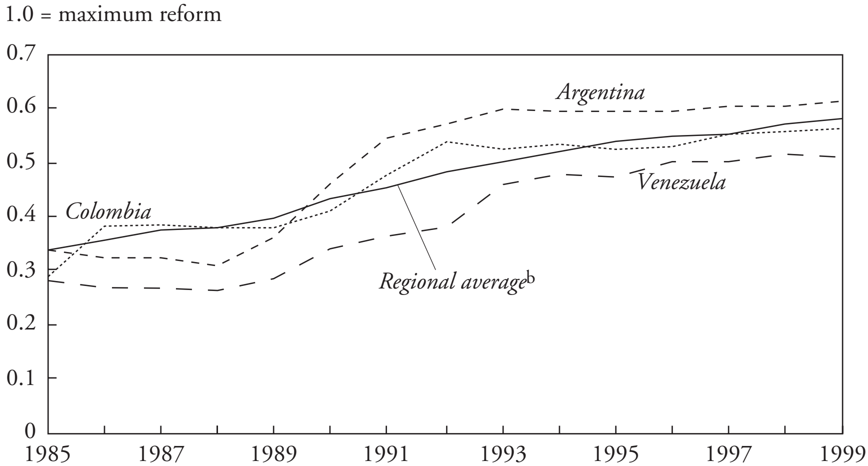
Figure 2 also shows the extent of variation across countries in terms of the timing, speed, and depth of reform. Chile was clearly among the first countries to pursue market-oriented reforms, so that by 1985 it was already ahead of the pack. Argentina and Peru, in contrast, started their reforms much later and in a much different fashion: the steep increase in the index in these countries in the late 1980s and early 1990s is a good illustration of what has come to be known as "shock therapy," whereas Chile, and later Brazil, followed a much more gradual approach. Venezuela and Peru are examples of countries that did not follow through with reform: starting from much the same, mostly unreformed position, Venezuela has lagged behind Peru and remains among the least aggressively reforming countries.

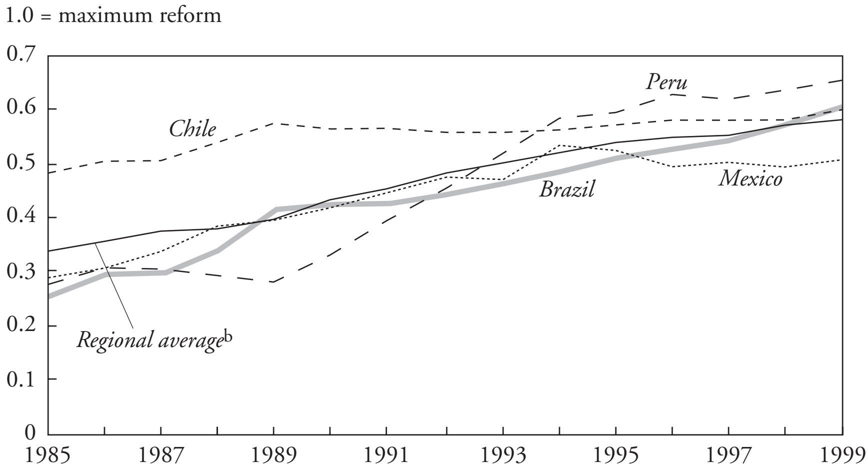
As a first step toward building an analytical framework for assessing the preconditions for successful reform, we identify here two possible general explanations for why the reforms implemented in Latin America have not produced unambiguously sustainable growth in income per capita. The first is that some of the reforms were not aimed at improving growth in income directly and immediately, but had other objectives instead. The second is that the reforms *did* attempt to generate growth but were thwarted by one or more obstacles, which may have taken different forms in different countries.

Not All Reforms Were Pro-Growth . . .

It is certainly the case that some of Latin America's reforms were not really aimed at accelerating growth of "measured" income per capita, at least in the short or the medium term, but instead were intended to improve living standards directly, by

Figure 2. *Index of Structural Reform in Selected Latin American Countries, 1985–99*[a]





Source: Lora (2001).

a. Index is an unweighted average of five subindices measuring the extent of trade, financial, tax, privatization, and labor reform.

b. Excludes Dominican Republic, Honduras, and Nicaragua.

improving the delivery of public services. And in fact, housing, health, and other social indicators did improve during the 1990s in the region as a whole, even in some countries where growth stagnated, and have continued to improve in the 2000s (box 2 and figure 3). These are impressive achievements, and they help explain why many Latin American countries show convergence toward industrial country levels in terms of social indicators despite failure to converge in terms of

Box 2. *Progress under Alternative Measures of Poverty: The Example of Colombia*

Measures of poverty according to *unsatisfied basic needs* (UBN) can give results that are very different from measures based on income, such as the standard poverty line. UBN-based poverty measures take into account the availability to households of both physical capital, such as access to public utilities and the quality of the dwelling, and human capital, in particular the educational attainment of the household head.

Colombia's recent experience is an interesting case in point. The UBN index considers five criteria for poverty: an inadequate dwelling, insufficient basic public utilities, excessive number of persons per room, school inattendance, and economic dependence. If one of these criteria is met, the household is considered to be in poverty; if two or more are met, the household is considered to be in misery or extreme poverty. The table below shows that by the UBN index, Colombia has seen a spectacular reduction in both poverty and extreme poverty in the last thirty years, much greater than when poverty is defined according to income.

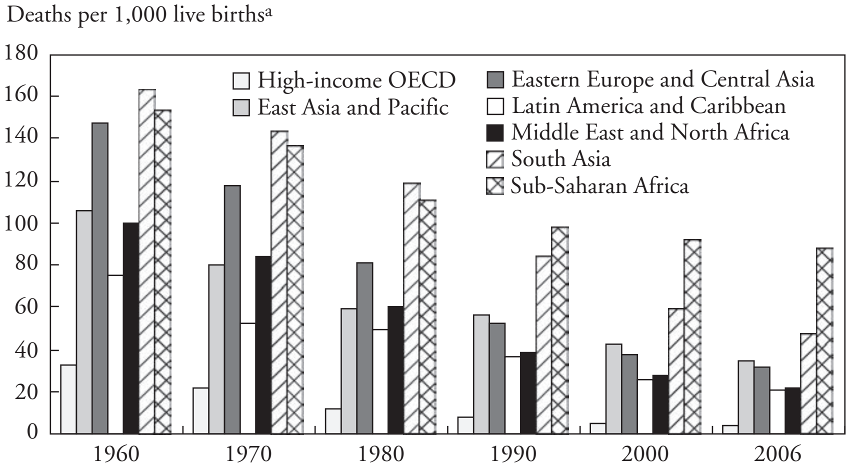
Other measures of structural poverty refer to the general health of the population. In particular, low infant mortality rates reflect adequate levels of nutrition as well as access to health care. In Colombia, the number of infants who die before the end of their first year fell from 77 per 1,000 in 1960 to 17 per 1,000 in 2006. In Latin America and the Caribbean as a whole for the same period, this indicator fell by a similar amount, from 75 per 1,000 to 20 per 1,000. The same is true for life expectancy. In sum, Colombia has witnessed great progress against poverty in terms of physical conditions, and much more progress by this measure than when measured in terms of income.

Colombia: Poverty as Measured by Unsatisfied Basic Needs, Selected Years
Percent of all households

Unsatisfied basic need (UBN)	*1973*	*1985*	*1993*	*2005*
Inadequate dwelling	31.2	13.8	11.6	10.4
Insufficient basic public utilities	30.3	21.8	10.5	7.4
Excessive number of persons per room	34.3	19.4	15.4	11.1
School inattendance	31.0	11.5	8.0	3.6
Economic dependence	29.0	15.9	12.8	11.2
Households in poverty (one UBN)	70.2	54.4	35.8	27.7
Households in extreme poverty (two or more UBNs)	44.9	22.8	14.9	10.6

Source: Departamento Nacional de Estadistica de Colombia.

Figure 3. *Infant Mortality by World Region, 1960–2006*



Source: World Bank, *World Development Indicators 2008*.
a. During the first year of life.

income per capita.[7] However, this phenomenon has been going on for at least forty years, and the extent to which the improvement in social indicators can be attributed to the reforms of recent decades (as opposed to general global trends, driven by improvements in technology and means of service delivery) remains controversial.[8]

. . . And Even the Reforms That Were Pro-Growth Faced Serious Obstacles

In general, however, the reforms that have been implemented since the 1980s crises *were* intended to promote income growth. When they failed, that failure can be attributed to one or more of three possible reasons. First, it could be that the reforms pursued were of second-order importance for growth given the region's unique circumstances: they might have worked in other parts of the world, but something about their nature prevented them from having a pro-growth impact in Latin America, or at least in some Latin American countries. In other words, the reforms were *not relevant* to the region.

7. Statements about convergence should be treated with care. "Convergence" is not invariant to nonlinear transformations, for example in the relationship between infant mortality and life expectancy. Here we mean, rather loosely, that the absolute gap with developed countries with respect to health and other social indicators has been reduced in the past twenty years, but the gap with respect to income per capita has not.

8. Even when there is clear evidence that reform improved public services (for example, the privatization of water supply in Argentina; see Galiani, Gertler, and Schargrodsky, 2005), this does not seem to have impressed the public. In some countries the population opposes specific reforms, and in a few these reforms are now even being undone.

Second, the reforms might have been pro-growth in a first-order sense, but were not properly implemented or were incomplete. They may have suffered from important problems of technical design, including problems of reform sequencing and lack of complementary reforms, or the design and implementation stages may have failed to take into account the particular features of Latin American countries, including institutional and political obstacles. This implies that certain binding constraints were evident before the reform started, but were not addressed, and therefore that figure 2 does not tell the whole story.

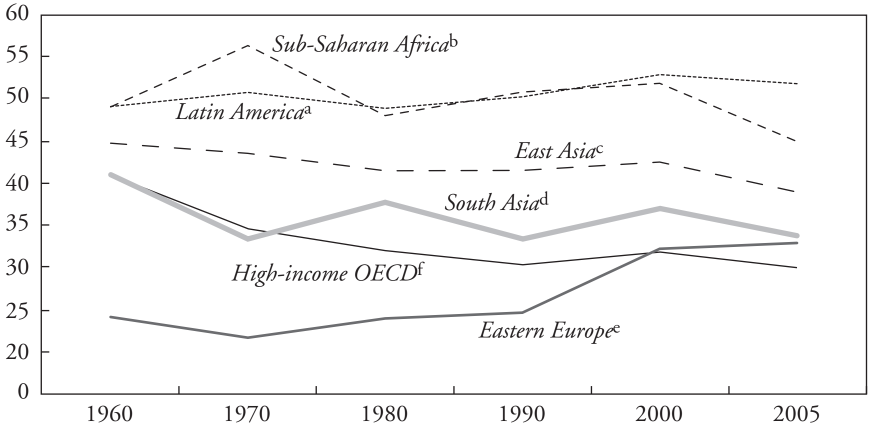
Third, the reforms may have been of first-order importance for growth, and they may have been adequately implemented, at least initially, but other, unanticipated problems may have emerged during (and perhaps even because of) the reform process. These could include not only domestic events but also external shocks, such as a sudden reversal of capital inflows resulting from a drying up of global liquidity.

The possibility that pro-growth reforms in Latin America faced fatal obstacles to their implementation raises the question of whether certain key structural characteristics of Latin American societies impede the successful implementation of reform. We focus here on two such characteristics and raise the following question: What can be expected in terms of reform from societies that share the combination of a *democratic political regime* and a *highly unequal income distribution?*

Nearly all the Latin American countries (Costa Rica is an exception) are young democracies—some might call them "forever young," given their frequent lapses from full democracy since independence in the nineteenth century. In the 1980s and 1990s a total of twenty-four countries in the region became democratic (Converse and Kapstein, 2006). Might this relative inexperience with democracy somehow interrelate with the region's sharply skewed income distribution to affect the outcome of reform? Recent literature on political economy helps to provide an answer. For example, Acemoglu and Robinson (2006) argue that in young democracies, the demand for income redistribution increases significantly as the poor acquire voting rights. To the extent that these demands remain unsatisfied, inequality might act as an obstacle to the implementation of pro-growth reforms. Others have also argued for a negative relationship between inequality and pro-growth reforms on the grounds that high and persistent inequality has an effect on the selection of reforms to be undertaken and on the institutions on which their implementation depends. For instance, Engerman and Sokoloff (2002) have documented that certain initial endowments have caused countries to end up with very unequal distributions of wealth, human capital, and political power; this inequality, in turn, has hindered the development of institutions that encourage economic activity, as the elite classes have tended to use public resources to perpetuate the existing distribution of income. Rodrik (1996) advances some alternative explanations for the negative relationship between inequality and

Figure 4. *Income Gini Coefficients by World Region, 1960–2005*

100 = most unequal



Sources: World Institute for Economics Development Research, World Income Inequality Database, version 2a; World Bank, *World Development Indicators*.

a. Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Peru, Uruguay, Venezuela.

b. Kenya, Côte d'Ivoire, Nigeria, South Africa, Tanzania, Zambia.

c. Hong Kong, Indonesia, Malaysia, Philippines, Singapore, South Korea, Thailand.

d. Bangladesh, India, Pakistan, Sri Lanka.

e. Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania.

f. Australia, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, United States.

pro-growth reform. First, in a highly unequal setting like that in Latin America, governments may face more pressure from powerful interest groups to make policy decisions that benefit those groups. Second, and alternatively, when inequality is high, governments may feel forced to undertake redistributive policies rather than policies that will maximize overall income and growth. Rodrik also discusses the importance of having a well-educated labor force for reforms to work.

Latin America is a region of great inequality in a variety of dimensions. Figure 4 traces income inequality for different world regions since the 1960s, as measured by the Gini coefficient. Throughout the period, together with Sub-Saharan Africa, Latin America has been one of the two most unequal regions in the world, and the gap, especially between Latin America and the high-income countries and emerging Asia, has been widening.

Data on inequality of land ownership and schooling, although sparse, also depict Latin America as "first among unequals." Behrman, Birdsall, and Pettersson (2008) report, for the five countries in their sample (Argentina, Bolivia, Brazil, Paraguay, and Uruguay), a Gini coefficient for land ownership of over 0.75 in the

Table 1. *Selected Indicators of Financial Access by World Region*[a]

Region	*Branches per 100,000 population*	*ATMs per 100,000 population*	*Loan accounts per 1,000 population*	*Deposit accounts per 1,000 population*
Latin America	8.2	13.9	77.9	411.5
East Asia	8.8	16.7	329.0	302.1
Industrial countries	35.9	67.2	451.0	975.6
World	8.4	16.6	80.6	312.9

Source: Beck, Demirgüç-Kunt, and Martinez Peria (2006).

a. Data are unweighted medians of the countries in the region as of 2004 or the most recent year for which data are available.

decade of the 1980s.[9] For a larger sample of Latin American countries, the schooling Gini averaged 0.46, compared with 0.29 and 0.39 for the high-income countries and East Asia, respectively, in the early to mid-1980s. Access to education remained highly unequal in Latin America in 2000: in that year the schooling Gini in the region was 0.42, compared with 0.35 for East Asia and 0.26 for the high-income countries. (Unfortunately, data on land distribution do not allow for comparisons in the most recent decades.)

Access to financial services in Latin America is also very unequal. Standard indicators of financial access in the region are usually below those of industrial countries, and some (especially the number of loan accounts per person) are significantly below those in East Asia as well (table 1). This is yet another manifestation of how large numbers of Latin Americans are not sharing the benefits of reform and the market system.

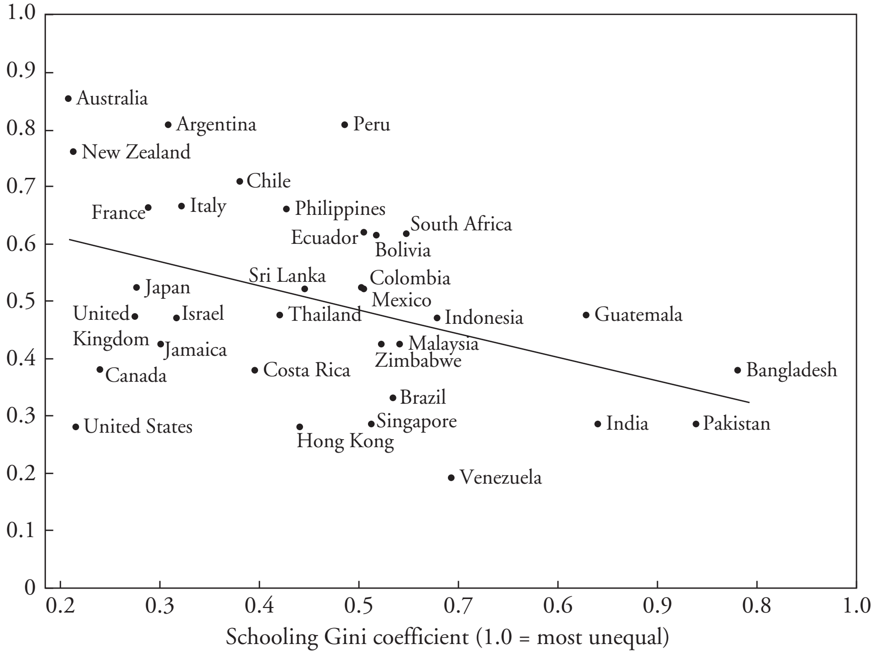
Differences in access to financial services *within* Latin America are also striking. Chile is an outlier in the region in terms of loans extended: its figure of 417 loan accounts per 1,000 population is even comparable with some industrial countries. Chile and Trinidad and Tobago also have many more ATMs per person (an average of 22.3 per 100,000 population) than countries like Honduras and Nicaragua (where the average is 3.1 per 100,000), but here even Chile's figure is well short of industrial country levels. The figures for deposit accounts display much less variation.

How do all these aspects of inequality in Latin America affect the reform process? Behrman et al. (2008) provide statistical support for a negative relationship between one form of inequality (education inequality) and the pursuit of reform (figure 5). Examining various indicators of advances in financial sector reform, they find consistently that longer-run inequalities in schooling are nega-

9. The paper by Behrman et al. was prepared as background material for this project.

Figure 5. *Financial Reforms and Schooling Inequality*

Improvement in financial liberalization index, 1973–95[a]



Sources: Abiad and Mody (2003); Thomas, Wang, and Fan (2001); authors' calculations.

tively related to an index of financial liberalization, in terms of both the level of liberalization achieved and the change over time.[10] (Box 3 briefly describes their methodology and presents the results of their analysis.) They also find support for the argument that structural inequality in the prereform period (as measured by schooling inequality) is associated with less reform during the 1990s, in terms of both the final level achieved and the advance each country made.

Thus, both theoretical arguments and empirical evidence support the proposition that inequality has had a negative effect on the reform process in Latin America—perhaps even on those reforms that were correctly conceived in technical terms. Unequal distribution of income, assets, education, and financial access may have restrained the advance of reform in the region and, perhaps more critically, may increase the potential for backlash against reform. The practical importance of this finding is that, in a setting like Latin America, reform efforts

10. Figure 5 also provides evidence for the argument that Latin American countries are very different from each other, and have been for decades. In the 1970s Argentina, Brazil, and Jamaica were clearly distinguished by their more equal access to education, whereas Guatemala was notorious for its lack of equality.

Box 3. *Statistical Estimation of the Relationship between Inequality and Reform*

Behrman et al. (2008) examine statistically what determines whether a country chooses to undertake reform. Following Abiad and Mody (2003), they hypothesize that "structural reform" (specifically, financial sector reform) occurs in response to some combination of external and internal shocks, combined with longstanding structural factors and the potential feedback from learning, if the reform appears to be successful—for example, in triggering more rapid growth. Relevant developments conducive to reform in the case of Latin America might be the apparent failure of the import substitution model, pressure from international institutions for structural reform, the increasing worldwide trend toward trade and financial liberalization, or a severe bank crisis.

These hypotheses are tested in a panel regression using data from thirty-seven developing and developed countries over the period 1975 to 2000 (divided into five-year periods), in which financial reform, measured as the level of a financial liberalization index, is the dependent variable. Schooling inequality is treated as a structural factor determining reform: the authors regard schooling inequality as a measure of long-term inequality, which changes only slowly. The other regressors are growth in real GDP per capita, average years of schooling, a dummy variable for the occurrence of a banking crisis, U.S. interest rates, a measure of the reform gap (measured as the difference between the country's actual level on the financial reform index and its potential level, estimated as the maximum value of the index), an index of the quality of institutions, and a dummy variable for the existence of an IMF program in the country.

The table below displays the main results of the study. The finding that schooling inequality is negatively related to financial reform, and significant in all specifications in which it is included, is consistent with the authors' hypothesis that schooling inequality is an important structural factor determining reform. These results also hold for different measures of financial reform, including the change in the financial liberalization index between 1973 and 1995.

Regressions of Financial Liberalization Index on Schooling Inequality and Other Variables[a]

Independent variable	*Regression*				
	1	*2*	*3*	*4*	*5*
Reform gap	–0.705***	–0.718***	–0.724***	–0.545***	–0.528***
	(0.073)	(0.074)	(0.074)	(0.089)	(0.094)
Schooling Gini	–1.150***	–1.201***	–1.214***		0.384
	(0.28)	(0.27)	(0.27)		(0.39)
Growth in GDP per capita in previous year	–0.0102**	–0.0113**	–0.0113**	–0.00968*	–0.00949*
	(0.0052)	(0.0054)	(0.0054)	(0.0051)	(0.0052)
Freedom House index[b]	–0.00990	–0.00883	–0.00724	0.00320	0.00437
	(0.013)	(0.013)	(0.013)	(0.012)	(0.012)
Federal funds rate	–0.0120**	–0.0109*	–0.0111*	–0.0122**	–0.0122**
	(0.0057)	(0.0058)	(0.0058)	(0.0055)	(0.0055)

(continued)

Regressions of Financial Liberalization Index on Schooling Inequality and Other Variables[a] *(continued)*

Independent variable	Regression 1	2	3	4	5
Dummy for presence of IMF program in previous period	0.0129 (0.037)	0.0127 (0.037)	0.0122 (0.036)	0.0128 (0.033)	0.0138 (0.033)
Dummy for bank crisis in previous period		−0.0374 (0.031)	−0.128 (0.090)	−0.197** (0.085)	−0.204** (0.087)
Dummy for bank crisis in previous period × schooling Gini			0.217 (0.19)	0.345* (0.18)	0.361** (0.18)
Average years of schooling, persons 15 and older				0.135*** (0.022)	0.160*** (0.036)
R^2	0.68	0.68	0.68	0.72	0.73

Source: Behrman et al. (2008), using data from the following sources: schooling Gini coefficient, Thomas, Wang, and Fan (2001); growth in real GDP per capita (period average in constant 2000 US dollars), World Bank, *World Development Indicators 2005;* Freedom House index (average of political rights and civil liberties, equally weighted), *Freedom in the World 2006;* Federal funds rate, Federal Reserve; IMF program dummy, IMF, "History of Lending Arrangements," various years; bank crisis dummy, Bordo et al. (2001, p. 55); average years of schooling of the adult population, Barro and Lee (2000).

a. The dependent variable is the level of the financial liberalization index described in the source. The sample in all regressions consists of 182 observations from 37 countries. Asterisks indicate statistical significance at the *10 percent, **5 percent, or ***1 percent level. Robust standard errors are in parentheses.

b. A higher score indicates lower institutional quality. The index is calculated as the average of the political rights and the civil liberties indices of the Freedom House Index.

need to take inequality into account in the design of reform. In this regard, the book by Birdsall, de la Torre, and Menezes (2008) develops what the authors call an "equity toolkit" for Latin America: a full set of policy recommendations that will promote growth while enhancing equity. A number of these recommendations are validated for various countries in the later chapters in this volume.

Finally, a note of caution. Identifying inequality (especially education inequality) as a constraint on reform does not imply that it is only the poor and the less educated who resist reform. Inequality is just one of the constraints (others are discussed below) that have prevented reforms from delivering sustainable growth and raising income per capita. It is therefore not surprising to find that there are no significant differences in discontent with the *outcome* of reforms across groups with different amounts of education. Data from Latinobarómetro support this contention.[11]

A Proposed Framework for Analyzing Reforms and Growth in Latin America

The discussion thus far makes clear the need to explore in a systematic way the particular factors that have either supported or obstructed the implementation of pro-growth reforms or made them more or less effective. This section develops a framework for analyzing the relationship between reforms and growth in the region. Chapter 1 discussed the differences between alternative approaches and the one presented here. The objective is to construct a framework that will allow researchers and policymakers to do the following:

- identify mechanisms through which alternative reforms can (or cannot) deliver sustained growth in Latin American countries
- understand the factors specific to Latin America that generate issues for appropriate design, problems for implementation, and other local constraints—political, social, or institutional—that affect how reforms can deliver growth
- derive at least some preliminary conclusions about why certain reforms in the past did not lead to growth, in order to advance feasible policy recommendations for the future
- focus attention on the political economy of inequality and access in the reform process, and
- most important, serve as an instrument for further assessments of the reform process in individual countries and for cross-country comparisons.

Pulling together the evidence and analytical discussion in the first two sections of this chapter, the framework is formed by four blocks, each one answering one of the following questions:

- What are the foundations for growth—the first-order underlying issues—in Latin America?

11. We are indebted to Pedro Dal Bo for arguments explaining the lack of support for reform among the more educated segments of the population. Data from Latinobarómetro (www.latinobarómetro.org) show that in some countries, such as Bolivia, Colombia, El Salvador, Nicaragua, and Peru, the more educated are even slightly less enthusiastic about the results of privatization than the less educated. However, these rankings vary from year to year and should therefore be viewed with caution.

• How, at the analytical level, can individual reforms impact the foundations for growth?

• What local features of the economy and society in individual countries act as potential constraints and obstacles, breaking the link from reforms to growth?

• How can these constraints and obstacles be addressed, either head on or by finding legitimate ways to work around them? Are there alternative reforms that can more effectively address the same purpose? Are there any private sector arrangements that can serve to reduce, contain, or appropriately get past these obstacles?

The rest of this section develops each of these four blocks. The third and fourth blocks explicitly recognize that countries in the region differ significantly one from another in terms of economic and social development as well as political features. Some of these differences are evident from the earlier discussion. A central point behind the conceptual framework is that major differences between countries imply that reforms will act differently and result in different outcomes in different countries—hence regional generalizations have limited usefulness. To exemplify the application of the framework to individual reforms and countries, the discussion makes reference to the existing literature on reform in the region.

What Are the Foundations for Growth in Latin America?

As discussed in chapter 1, this framework identifies economic growth with *market-based* growth. Although this definition by no means precludes a sensible role for government (and indeed, government interventions to deal with market imperfections are encouraged), the Task Force acknowledged that the Latin American experience with government-led growth has been disappointing and that such a model is not advisable for the region. Moreover, in the context of an open capital account (the type of regime chosen by most countries in the region since the late 1980s), the adequate functioning of a market economy is a necessary condition for the sustainability of growth gains (see chapter 1 for further discussion).

The Task Force identified five foundations for market-based growth in Latin America. The first three are essential for the appropriate functioning of any market economy. The last two are more specifically a concern in Latin America. By recognizing the region's specific features and its long history of economic, social, and political crises, the foundations try to capture the essential need for economic stability and social inclusion for growth to be sustained. The five foundations are

• Secure *property rights* for the population, so that people can expect to benefit from their investments and cannot be unexpectedly expropriated by the state or by the politically powerful.

• Sufficiently *equal opportunities* for broad segments of the society, so as to level the playing field in market-based interactions. Broadly speaking, this means lowering barriers to entry into business to people without political connections or large stocks of wealth. This is distinct from the first foundation: a person might have secure property rights but no way to access new market opportunities, for example because regulatory requirements create a high fixed cost of doing business, or because ordinary citizens cannot raise capital through bank loans or in other ways. Problems with this foundation are apparent in Latin America, where, as discussed above, lack of access has been an important manifestation of inequality, which in turn constrains pro-growth reform.

• Sufficient *economic and political competition* to avoid capture of the state by elites of one kind or another. This is distinct from the first two foundations, because even if ordinary people have secure property rights and meaningful opportunities, the considerable resources of the state might still be funneled toward a relatively few favored individuals or companies. Recent research on a wide range of countries indicates that political connections of various kinds remain important and a major brake on development.

• Latin America's frequent economic and financial crises during the 1980s and since have often resulted in sharp recessions and in the need for fiscal adjustment to restore macroeconomic balance. These adjustments, in turn, have required drastic cuts in social expenditure and in vital infrastructure spending, with adverse consequences for the poor and for long-term growth. Although the major economies in the world can sometimes get away with maintaining large macroeconomic imbalances for prolonged periods (the United States being a current example), the characteristics and history of Latin America imply that investors will tend to flee at the first sign of trouble, deepening the financial difficulties and exacerbating the crisis. Thus, *macroeconomic stability* is a key foundation for sustained growth in Latin America, necessary to ensure that sufficient public funds are allocated to pro-growth reform efforts and, conversely, that the reform process does not have to be interrupted to deal with macroeconomic imbalances.

• Given the recent history in Latin America of discontent with the outcome of reform (box 1) and disillusion with various alternative development models, a fifth foundation for growth is the need for *broad sharing of the benefits of growth* among the population. Realistically, only a minority of the population will ever want to make the kind of productive investments for which the first three foundations are of primary importance—in all societies, most people work as employees or in small-scale independent activities, or are outside the labor force, living as pensioners or students or other dependents. Yet these people, too, need to benefit from reform if there is not to be a serious political backlash against it—and this is true whether reform succeeds or fails in restoring economic growth. If GDP per capita grows but most people see no increase in their real income, they may become opponents of reform, and their opposition may lead to consequences that undermine the sustainability of growth.

The importance of this last foundation cannot be overstressed. As discussed above, important segments of the population in a number of Latin American countries today are voting for redistributive policies. Taking these demands into account is essential for long-term growth.

Before leaving this subsection, an important clarification is needed. Although the framework emphasizes the central role of the identified foundations in achieving sustained growth in Latin America, the Task Force fully acknowledges that there can be episodes where growth is ignited without improvement in any of the foundations. For example, a sharp improvement in the terms of trade can spark growth—indeed, this has happened several times in the region, including during 2003–08. The Task Force maintains, however, that for such growth accelerations to be sustainable, the foundations for growth identified above need to improve.

How Do Reforms Impact the Foundations for Growth?

Every reform affects economic growth differently. Therefore any analysis of the potential for reform to have an impact on the foundations for growth requires a list of reforms to be considered. However, the list of all the reforms that have been or might someday be implemented in Latin America is certain to be both long and varied, and each of these reforms will cover a number of different issues and activities and thus can be disaggregated further.

The Task Force strongly believes that the task of identifying which particular reforms are needed to strengthen the growth foundations in a given country should be left up to the country itself. In the chapters that follow, experts from five countries in the region each choose a set of reforms to analyze for their country. These reforms will, of course, include some that have already been implemented and some that have not but that are considered essential for the future. The Task Force makes no presumption about what reforms are best for what countries, and it certainly does not presume that a common set of policies is right for all countries in the region. However, to illustrate the workings of the framework, we offer the following, necessarily incomplete, classification:

- reforms that directly improve the workings of the market: trade, financial, labor, pension, privatization, and land titling (these include adequate regulation, including consumer protection and antidumping arrangements)
- reforms oriented toward the provision of social services: education, health, and the social safety net
- reforms of economic and financial infrastructure: central bank independence, decentralization, tax collection, budgetary institutions, customs, registries, regulatory agencies, and supervisory authorities

Table 2. *Potential Impact of Reforms on the Foundations for Growth: An Illustrative Example*[a]

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

a. 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.

b. The table illustrates the potential impact of telecommunications privatization; privatization of other state enterprises might have somewhat different impacts.

c. Reform of other social services (for example, health care) would likely have similar impacts.

- reform of political institutions: the judicial system, the legislature, and electoral processes; and
- reform of governance institutions: measures to control corruption and improve the rule of law.

Table 2 lists several of the main types of reform and indicates which of the foundations each type has the *potential* to affect. This is, of course, just an overall summary assessment. The matching of reforms with foundations is derived from a review of the literature on the effects of individual reforms on growth, but it should be taken only as illustrative and not representing every case and circumstance. A blank cell means that the indicated reform does not affect the indicated growth foundation; a single checkmark indicates a positive impact of the reform on the growth foundation, and two checkmarks mean a very strong positive effect. A question mark implies that the direction of the impact of the reform on the foundation depends on other factors; the reform could even have a negative effect. A good example is trade reform. Reform that opens the country further to international trade should promote *equal opportunity,* by lowering barriers to entry in the affected sectors, and it should strongly enhance economic *competition* in those sectors. But if trade reform is implemented without adequate mechanisms to compensate the losers, it could have a negative impact on the *broad sharing of the benefits of growth.*[12]

The most important conclusion to be drawn from table 2 is that, according to the literature, a wide range of reforms have the *potential* to positively impact at least some, and in some cases most, of the foundations for growth. A key issue, therefore, is to assess whether each reform, when and where it has been applied, has delivered on its potential. Most important is whether those reforms that had the potential to impact the "broad sharing" foundation actually did so, because, as stressed above, this foundation is central to the sustainability of growth in Latin America.[13]

What Might Prevent Reforms from Delivering Growth?

A reform might fail to reach its potential for a number of reasons, and therefore it is important to analyze the various obstacles to reform and the constraints to which various reforms are subject. We leave open the possibility that a particular reform might not have had a significant *direct* impact on growth, but did facilitate the implementation of other reforms that were clearly pro-growth, thus promoting growth *indirectly.* Argentina's reform of education in 1991–99 is a clear example. By bringing together two political actors from different political factions within the ruling party (the Justicialist Party) at the time, this reform allowed the passage of other reforms that more directly promoted growth in the mid-1990s (see Corrales, 2004).

What factors might act as obstacles to the success of a reform that has the potential to enhance, directly or indirectly, the foundations for growth? The list is long. Some of these factors are universal, threatening successful reform anywhere in the world. However, as we will see next, others are associated with the particular features of Latin American countries (which can differ from country to country). Following the discussion above, we can identify the following sets of obstacles:

- *Problems of relevance.* A reform may be inappropriate for a country, either because the country is not ready for it or because the country's particular features make the reform undesirable. For example, Rojas-Suárez (2002, 2008) argues that implementation of the bank capital requirements proposed by the Basel Com-

12. The impact of trade liberalization on the growth foundations is complex, since the effects on relative wages over time might create new losers as the process evolves. Compensation policy therefore needs to be designed in a dynamic fashion and not limited to addressing the initial effects of trade liberalization.

13. See Birdsall and Londoño (1997) for evidence.

mittee on Bank Supervision (the so-called Basel II requirements) would be inappropriate for the Latin American region because, among other reasons, the risk assessment techniques proposed in Basel II would tend to intensify the procyclicality of bank credit. This would increase the fragility of the countries' financial systems rather than reduce it as intended by Basel II.

- *Problems of design.* A reform may fail to properly align incentives with desired outcomes. In other words, even if the reform is intended to have a positive impact on one or several of the growth foundations, it might not create the correct incentives for this to occur. This could happen for a number of reasons:
  - *Technical inadequacies.* The list of examples is quite long. A good illustration is the case of pension reform in Bolivia. This reform replaced an antiquated, overly generous pay-as-you-go system with a very ungenerous, fully funded system, creating a strong incentive for workers (who could choose between the two systems) to retire under the old system. The huge fiscal expenditure that resulted had a negative effect on the macroeconomic stability foundation. Peru's pension reform provides another example: here increasing coverage was not made part of the reform, which thus missed an opportunity to impact another foundation, the broader sharing of the benefits of growth (see Morón, 2006).
  - *Lack of needed sequencing.* The experience with trade reform in several Latin American countries provides examples of this common design problem. In most of these countries (Chile being a notable exception), the capital account was liberalized simultaneously with the current account. In a context of fixed exchange rates, this lack of proper sequencing resulted in a real appreciation, which eroded the potential gains from trade.[14] Another classic example of inadequate sequencing in the region, first identified by Díaz-Alejandro (1985), is the liberalization of financial markets *before* an appropriate supervisory framework is put in place. A number of authors identify this problem as an important factor explaining the eruption of banking crises in Latin America in the 1980s and 1990s (see, for example, Hausmann and Rojas-Suarez, 1996).
  - *Lack of complementary reforms.* This is another common problem in many countries in Latin America. A good example here is the need for adequate budgetary institutions to complement decentralization. As discussed in Wiesner (2003) and Tanzi (1995), a number of decentralization efforts in the region during the 1990s generated only limited growth gains and instead contributed to fiscal instability.
  - *Lack of adequate adaptation.* Sometimes a reform that has worked elsewhere (typically in industrial countries) has failed in Latin America because it

14. See, for example, Devlin, Ffrench-Davis, and Griffith-Jones (1995).

was not properly adapted to the particular features of Latin American economies. For example, the bank capital requirements suggested by the Basel Committee call for banks to hold capital equivalent to at least 8 percent of assets. This requirement usually works well in industrial countries, but the recommended ratio might prove too low for the more risky financial environments of Latin American countries.

- *Obstacles from local conditions.* Even if a reform is correctly designed, at least initially, features of the local environment may pose barriers to its appropriate implementation or its effectiveness. These obstacles include
  - *Institutional constraints.* For example, privatization might fail to deliver growth if the agency in charge of regulating the privatized entities lacks sufficient power to promote and protect competition. Torero, Schroth, and Pasco-Font (2004) note that the privatization of telecommunications in Peru brought about important improvements for consumers in terms of coverage, quality, and price of the services. However, the telecommunications regulatory agency still lacks authority over the licensing of operators or their rights to use spectrum, as well as capacity to exercise merger control. These tools are essential to promoting competition in the sector, and their absence undermines the competition foundation.
  - *Adverse political dynamics, including lack of legitimacy of the reform.* This constraint relates to the demands of different segments of the population as these express themselves through political interest groups. As was stated in box 1, some of these demands are consistent with pro-growth reform. Others, however—most notably those calling for expropriation and trade protection—clearly run counter to strengthening the foundations of growth. For example, domestic protectionist interests in Brazil mobilized themselves more effectively than did the pro-liberalization forces and succeeded in preventing trade reform (see Abreu, 2004). Expropriation directly violates the property rights foundation, and protectionism undermines both competition and equal opportunity.
  - *Insufficient implementation capacity.* In many Latin American countries the public sector has too few personnel with the skills, especially management skills, needed to implement reform effectively. Decentralization is one of the reforms most affected by this obstacle, because subnational governments are even more prone than the central government to such skill shortages.[15]
  - *Inequality of income, assets, and education.* Inequality was identified above as both an important constraint on implementing pro-growth reform or its components and a threat to the effectiveness of reform once implemented. An

15. As discussed by Daughters and Harper (2007), lack of implementation capacity is one of the major obstacles to successful decentralization in many Latin American countries.

example relevant to a number of countries in the region is the constraint on effective bank supervision, and therefore on macroeconomic stability, derived from the concentration of wealth. The concentration of assets in the hands of a relatively few very wealthy individuals makes it easier for banks to engage in lending to insiders.[16]

These obstacles are not always independent of each other, but rather can interact. In some cases problems of design can reflect insufficient analysis or even bad advice, whereas in others the implementation of a poorly designed policy can be the result of capture by particular political interests, or of institutional deficiencies.

How Can Constraints and Obstacles Be Overcome? Are There Alternative Initiatives?

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 analysis presented in the next five chapters. Just to provide a flavor of what is to come, here we provide a few very succinct examples of proposals already found in the literature. Some are of general relevance, while others apply to individual country experiences.

Dealing with Problems of Design

- To hedge against external shocks in economies with liberalized trade systems, commodity exports can be taxed during boom periods and the proceeds used to finance a special fund to counter excessive volatility and to finance incentives for local export diversification and innovation. The copper stabilization fund in Chile is considered a successful tool in this regard.[17]
- Since the specific recommendations of the Basel Committee for Banking Supervision are considered inappropriate for Latin America, at least in the short run, some have suggested that countries in the region implement ex ante loan-loss provisions,[18] as a mechanism to improve the quality of the banking system, and rely more on this supervisory tool than on capital requirements (Rojas-Suárez, 2002, 2008).
- To reap the potential gains from decentralization, countries can design clear rules within the transfer system, with special emphasis on how the funds are distributed among different regional and local governments.[19]

16. See De Juan (1996).

17. Because economic stability is considered essential for decreasing poverty and inequality, Birdsall et al. (2008) also include stabilization funds in their equity toolkit.

18. Ex ante loan-loss provisions require that provisioning increase in good times. In bad times, when nonperforming loans increase, the accumulated funds can be used to offset the weakening of bank capital.

19. Daughters and Harper (2007) assess the quality of the transfer systems and other achievements in the decentralization efforts of fourteen Latin American countries.

• To help deepen domestic capital markets so that they play a more central role in raising investment and economic growth, pension funds can be allowed to broaden their investment base. One way to do this is through innovative financial instruments that cater to the investment needs of Latin America, in a manner compatible with investors' demand for adequate returns and the safety of their investments. For this purpose a variety of new instruments have been proposed by the Latin American Shadow Financial Regulatory Committee (2005).

• Countries should not mimic the usual tax mix of industrial countries, but instead take into account the importance of the informal sector. As an example, Artana (2004) proposes a specific tax structure for the case of the Dominican Republic.

• The proper design of a fiscal budgetary institution requires introducing transparency rules at the same time that fiscal rules are introduced. Filc and Scartascini (2004) summarize progress at the country level in designing procedures and practices according to which fiscal budgets are drafted, discussed, and implemented in the region.

Dealing with Obstacles Arising from Local Conditions

When confronted with an institutional or political constraint, the first-best solution is obviously to remove the constraint. But this might not be feasible in the short run. Hence, the following recommendations fall in the category of *second-best arrangements:*

• Countries can organize a process aimed at constructing a private-public sector alliance to develop a consensus about long-term strategies that would result in both private and public welfare gains. Examples are public-private partnerships for deepening financial systems, and strategies to support the private sector in overcoming obstacles for improved competitiveness.

• To overcome the constraints imposed by an inadequate judicial system on bank credit to small firms, countries can collect and disseminate information through private credit bureaus. These and other proposals to improve access to financial services in Latin America are contained in Secretaría General Iberoamericana (2006).

• To reduce social exclusion from pension funds in Peru, the government could introduce noncontributory pensions for older workers in extreme poverty. Although this would increase government spending, it should be considered as a preemptive measure to bolster the political sustainability of the pension reform (see Morón, 2006).

• To stimulate societal demand for education reform, evaluation results can be used in a transparent way both for teacher selection and for determining acceptance to universities. In addition, to minimize bureaucratic resistance to producing, analyzing, and disseminating school tests, a dedicated unit could be created for that purpose that is independent of the ministry of education (see Corrales, 2004).

• International tax agreements can help overcome political resistance to changes in the status quo. As Artana (2004) notes, in the Dominican Republic, trade liberalization under CAFTA (the Central American Free Trade Agreement) created an important fiscal loss that everyone involved (political parties, various business organizations) knew needed to be repaired.

• In Brazil, to reduce the incentives for politicians to use the courts as a tool to advance their political interests, increased use could be made of the ADC (Ação Declaratória de Constitucionalidade, or Direct Action of Constitutionality), which allows the Supreme Court to declare the constitutionality of normative laws and acts, with binding effect over the lower courts (see Sousa, 2007).

Some Lessons from the Framework

The following parting thoughts summarize what the Task Force learned, in the process of designing the framework described in this chapter, about the linkages between reforms and growth in Latin American countries:

• A most important conclusion is that the framework can indeed be a powerful tool for designing and implementing pro-growth reforms. As the following chapters will show, the application of the framework to specific country experiences yields a systematic identification of constraints and obstacles that have prevented reforms from maximizing their growth potential. The chapters show that the framework helped in generating country-specific recommendations to overcome these problems.

• In setting the stage for developing the framework, the Task Force concluded that many social demands that could be read as opposing reforms could instead be seen as complementary to market-led growth (box 1). For example, pro-access and pro-transparency movements call for less inequity and less corruption, both of which positively affect long-term growth. The strength of these demands varies from country to country and needs to be taken into account when designing reforms. After all, some reforms, especially those dealing with institutions (such as judicial reform), may find fertile ground for their appropriate implementation in countries with pro-growth social demands.

• The existing literature and the discussion in the following chapters show that most of the reforms of the 1990s had the *potential* to positively affect the foundations for growth. However, in many cases the reforms as actually implemented only weakly addressed the first-order problems that undermine growth in Latin American countries. In particular, as Birdsall et al. (2008) emphasize, the extreme inequality and widespread poverty in many of these countries, both of which are associated with educational shortfalls and the concentration of resources in the hands of a few, received too little emphasis—the "broad sharing" foundation, essential for growth in Latin America, was not properly addressed. To put this in the language of property rights: the problem was not how to improve average property rights or even marginal property rights, but rather how to improve the property rights, broadly construed, of people living on the fringes of society.

• Instead, in most countries in the region, the emphasis was on designing and implementing reforms that had proved effective in societies with much greater access and less poverty and inequality, such as in Western Europe and East Asia. In those societies, pushing for better functioning of the state, or even just lowering inflation and opening the economy to trade, created meaningful opportunities (and higher real wages) for a broad cross section of society. In contrast, when such reforms were implemented in Latin America, the relatively well educated and people with significant initial resources gained, but the rest of society experienced little or no increase in real earnings (although they did see some real improvement in access to health care, clean water, and decent housing). In other words, social indicators converged, but incomes did not. This disparity of outcomes explains much of the emerging reform fatigue and the potential (and in some places actual) backlash against reform.

• The underlying issues of inequality and poverty were not effectively addressed, not because policymakers were unaware of the issues, but rather because these are very hard problems given Latin America's existing power structures and economic and political institutions. These problems *can* be addressed, but the past fifty years have shown that progress on these fundamental issues is difficult. It remains so today, although, as stated above, support for improving equity is perhaps stronger than in the past. Countries are trying to improve equity in different ways. In some, expropriation and unilateral repudiation of contracts are likely to undermine property rights and make growth less likely, and a return to greater state control of the economy is unlikely to produce sustainable growth. In other countries, however, the potential for organized, market-based efforts for broadening opportunities has started to develop.

• Some lessons from other emerging markets can be encouraging for Latin America. Growth per se does not necessarily lead to better institutions. But growth of the kind seen in parts of Asia has generally created the kind of constituencies that favor further reform. Institutional change has come about, in large part, because broad-based homegrown groups have flourished, and because they have demanded better protection, greater access, and other institutional improvements, which in turn feed back to sustain growth.

• As the country case studies in the next five chapters will show, problems of design sometimes weakened the capacity of reforms to affect the foundations for growth. These problems reflected a combination of technical inadequacies, sequencing problems, and lack of necessary complementary reforms. But the Task Force believes that the more important problems facing reform had to do with institutional and political obstacles. In some cases the main problem was political capture of some key institutions; in others, the force of certain special interests was the stumbling block; in still others, extreme inequality emerged as a major obstacle. Lack of capacity to carry through the needed actions also seems to have played a crucial role.

• The country studies will also show the importance of complementarity between reforms. For example, many reforms failed to realize their growth potential partly because of deficiencies in the judicial system.

• Although the Task Force emphasizes the importance of country-level differences for the design and implementation of policies, it is necessary to continue examining lessons from other parts of the world for their relevance to Latin America. One such lesson is that emerging Asia has made substantial progress since 1960 using a strategy of promoting manufactured exports to create new constituencies for further reform. The middle-income countries that have acceded to the European Union—such as Portugal and Spain in the 1980s—have made similar progress starting from higher levels of income than those in Asia, and thus their experience may prove more relevant to Latin America.

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