11

Summing Up

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The preceding chapters have reviewed the economic situation of Latin America and developed a set of policy proposals intended to address the major problems facing the countries of the region, so as to put them back on the road of catch-up growth that most people thought they had achieved before the debt crisis. The aim of this chapter is to summarize these proposals and place them in the context of past and competing ideas, as well as relating them to other major areas of social concern.

The book started by examining where Latin America has come during the past decade, since market-oriented reforms became widespread. The record is a mixed one. The per capita growth that was so conspicuously absent in the 1980s did return in the 1990s, but at less than half the rate recorded during Latin America's golden age, between 1950 and 1980,[1] and it was much lower in the second half of the decade than the first.

The obvious explanation for this deterioration in performance is the series of crises that erupted in emerging markets, starting with Mexico in 1994. Even at the rates achieved in the first half of the decade, however, it would have taken many more decades for incomes in Latin America to reach the levels that already prevail in industrial countries, let alone to catch up with where those countries can expect to be by then. Income

1. Per capita growth per year was 2.9 percent between 1950 and 1980, –0.1 percent in the 1980s, and 1.3 percent from 1990 to 2000 (data from *ECLAC Notes* and World Bank, *World Development Indicators*).

distribution just about stopped getting worse, at least in the region as a whole, but there was no widespread improvement, despite the fact that distribution is more inegalitarian than almost anywhere else in the world.[2] Social indicators have continued to improve, but that was true even during the debt crisis. The region has witnessed major crises in its three largest economies and in Ecuador, Venezuela, and Uruguay. This was far from the dramatic improvement in the region's performance that reformers had expected to result from widespread adoption of the liberalizing reforms that they advocated. What went wrong?

One hypothesis is that the whole strategy of what critics label "neoliberal reform" was mistaken. If that hypothesis were correct, then presumably one would expect to see the countries that had most resolutely resisted "neoliberalism," which means Cuba and Venezuela, enjoying the biggest advance in living standards, whereas those that had embraced it first and most decisively, like Chile, would be lagging behind. Statistics do not confirm this hypothesis; setting per capita income as 100 in 1990, in Cuba it had fallen to 79 and in Venezuela to 97 in 2000, whereas in Chile it had risen to 147.[3] It is true that the price of copper (still Chile's staple export) did better than that of either sugar (Cuba's staple) or petroleum (Venezuela's staple) in the 1990s, but the price of commodity exports is not a good predictor of economic performance over a period as long as a decade.

A second hypothesis is the exact opposite of this: that the reforms were not pushed far enough. Fernandez-Arias and Montiel (1997) estimated econometrically (on the basis of data from all developing countries) that the reforms had accelerated growth by about 2 percent a year, which was partly offset by a deterioration in the international environment. They estimated that more vigorous reform along the same lines, to match the performance of the East Asian countries, could have produced a further acceleration of about 2.5 percent a year. A later paper by Lora and Panizza (2002, 13) estimates that, despite a somewhat smaller payoff from reform than had been estimated earlier, per capita income in 2000 was on average 11 percent higher than it would have been without reform. Even smaller, though still positive, effects are found by Stallings and Peres (2000). In short, the verdict of serious work is that the impact of the reforms was indeed positive, although disappointingly small.

2. The unweighted average of the Gini coefficient for the 26 countries reported in the United Nations Development Program's 2001 *Human Development Report* is 50.4 percent, as against an average for the rest of the world of 36.9 percent. Only in southern Africa is income distribution comparably skewed. The poorest 10 percent of the population gets an unweighted average of 1.5 percent of total income (varying from a maximum of 2.9 percent in Jamaica to a minimum of 0.4 percent in Honduras), whereas the richest 10 percent gets an unweighted average of 40.2 percent (varying from a minimum of 28.9 percent in Jamaica to a maximum of 48.8 percent in Nicaragua).

3. This is according to *ECLAC Notes*.

A third hypothesis is that it takes time to benefit from market-oriented reforms. Thus it took well over a decade from the time in 1974 when Chile first started implementing such reforms until many people were prepared to call it an economic success story, and only after this did it become a model that other countries might find attractive to emulate. But then of course one is led to ask why it took so long. China did not have to wait for 15 years after it initiated market reforms in 1978 to benefit, nor did India have to wait 15 years after 1991; both started to benefit within a couple of years. What did they do right that Latin America did wrong?

The obvious answer is that they avoided macroeconomic crises of the sort that devastated Chile in 1982, Mexico in 1994, Argentina in 2001, and so on. Remember that there was a false dawn in Chile in the late 1970s when it looked as though Chile might be a success story in the making. But then mistaken macroeconomic policies—a fixed exchange rate to reduce inflation regardless of the loss of competitiveness this entailed, combined with relative freedom for capital inflows and financial deregulation without effective supervision—led to the disaster of the 1982 collapse.[4] In the following years, Chilean policy became far more pragmatic. The authorities aimed to achieve and maintain a competitive real exchange rate, and they were content with a very gradual approach to disinflation. Supervision of the financial system became a priority. After the restoration of democracy in 1990, they adopted the *encaje* to limit capital inflows and pursued an anticyclical fiscal policy (Ffrench-Davis 2000). In conjunction with the market-oriented microeconomic policies that were then securely in place, the result was the impressive Chilean progress of the 1990s.

A fourth hypothesis is that the region was hit by a series of exogenous shocks that repeatedly disrupted the progress that was beginning to be achieved. The tequila crisis in Mexico in 1994-95, the falloff in capital inflows and the decline in commodity prices after the East Asian crisis in 1997 and the Russian crisis in 1998, and the Brazilian crisis in 1999 all reverberated around the region, as did the Argentine crisis and the new Brazilian panic as this was being written. But then one has to ask whether these shocks were truly exogenous to the policies being pursued in the region; surely the East Asian and Russian crises were, but the other crises originated within the region. The crisis vulnerability of the region was one of the major reasons for its disappointing performance.

In sum, the second and fourth hypotheses help to explain why the growth performance of Latin America was so disappointing. Although the reforms of the 1990s were in the right direction, they could usefully have been pushed a lot further. And crises, sometimes exogenous but too often due to short-sighted policy choices within the region, played an overwhelmingly important role in interrupting progress. Crises have some-

4. People tend to forget it now, but the 14 percent collapse in GDP was even larger than that experienced by Argentina in 2002.

times been caused by bad—that is, dogmatic—macroeconomic policies, as argued in the discussion of why it took so long to benefit from the new policy regime in Chile.

To elaborate on the last point, it is clear that at times the reform process was less than ideal. Although the evidence (some of which is cited in chapter 2) shows conclusively that privatization has in most cases brought important benefits, the fact is that on occasion privatizations were carried out without the necessary care to ensure that the privatized firm was selling in a competitive market or, where that was impractical, was properly regulated. Trade was liberalized without the necessary complementary concern to make sure that the exchange rate was sufficiently competitive to induce vigorous export growth. Perhaps because they are largely in the public sector, education and training did not receive the priority necessary to nurture the growth of a modern knowledge-based economy.

A deeper problem was that the institutional basis for an ambitious program of policy reform was weak: civil services, judiciaries, and the teaching profession were ill adapted for the modern world. And the reform programs themselves were too narrowly focused on restoring growth, and never really faced up to the need to expand employment in particular and opportunities in general so as to give poor people a chance to contribute their talents and begin to correct the highly unequal income distributions that history has bequeathed to the region. It is true that those who have worried about income distribution in the past have tended to be populists whose programs ended up impoverishing those they were supposed to help along with the rest of society, but that just says that one needs to be more intelligent in tackling the problem, not that it should be brushed under the rug.

Given this diagnosis of the reasons for Latin America's disappointing performance in the past decade, this book's next nine chapters sought to develop an agenda for the future. The following section of this chapter summarizes what they say.

The New Agenda

The first topic addressed is how to modernize the state (chapter 2, by Pedro-Pablo Kuczynski). Much of the focus in around 1990 was on cutting back the bloated role that the state had assumed in most Latin American countries during the decades that culminated in the debt crisis. Fiscal deficits got far too large; the government set itself up as producer of many goods and services that can be provided more efficiently by the private sector; government regulation of economic activity was oppressive; and government was far too centralized. But a desire to prune back government in those areas is not the same as a desire for minimalist government:

"A strong and capable state is necessary to support markets, and an arbitrary and corrupt state can impede their development."[5]

The most important reason for wanting to prune the state of those activities it does not do well is to allow it to concentrate on the key functions that it alone can fulfill: providing security, the institutional infrastructure of a market economy, and public goods; internalizing externalities; and looking after those members of society least able to care for themselves. The agenda of "second-stage reforms" (Naím 1994; Burki and Perry 1998) is devoted to building the institutions—a modern, efficient, noncorrupt civil service and judiciary being perhaps the most central of them—that will permit those core functions to be fulfilled efficiently.

The duty of looking after those members of society least able to care for themselves is one that the historical legacy of Iberian colonialism has led Latin American states to perform particularly poorly. The result is that the region features the most inegalitarian income distributions in the world. In seeking to remedy this, one must recognize that most of the first-generation reforms do not have much traction (as Nancy Birdsall and Miguel Székely show in chapter 3), although except for financial reforms they appear to be marginally helpful rather than massively unhelpful, as the antiglobalization ideologues (e.g., Houtart and Polet 2001) maintain.[6] The legitimate criticism of the reforms is not that they have contributed to poverty, but that they have so far failed to address the structural causes of poverty. The next generation of policy reform clearly needs to pursue that challenge.

Birdsall and Székely look less to the traditional antidote to unequal income distribution, a massive redistribution of income through the tax system ("Band-Aids"), than to measures to empower poor people to exploit the potentialities of a market economy ("bootstraps"). Of course, one should still strive to make both the system of taxation and the pattern of public expenditures progressive, but one of the things that money is good at buying is the ability to minimize tax obligations. Even with careful attention to tax design and enforcement, one may not be able to do much better than achieve a roughly proportionate tax system, at least without serious damage to incentives. The fiscal system as a whole can still have a progressive impact if the pattern of public expenditure is biased toward poor people, by focusing heavily on the universal provision of such basic, opportunity-enhancing public services as education and health. These are

5. World Bank, *World Development Report 2001/2: Building Institutions for Markets*, 26.

6. However, both Berry (1997) and Morley (2001) concluded that reforms have generally tended to increase inequality. Morley estimates that trade reforms were regressive, whereas opening the capital account had a progressive impact, the exact opposite of Birdsall and Székely's results. What everyone agrees on is that the impact of the reforms was small "compared to other factors like growth, inflation, and changes in education structure" (Morley 2001, 20).

perhaps the most potent instruments available to empower poor people, although they can usefully be supplemented by land reform, access to microcredit, and legal recognition of de facto property rights in the informal sector (de Soto 2000).[7] These are the major instruments that have been identified as ways of empowering poor people to take advantage of a market economy, and their deployment should be high on the policy agenda.

Revamping the fiscal system so as to reverse its traditional tendency in Latin America to aggravate income inequalities is one of several challenges to fiscal policy discussed by Daniel Artana, Ricardo López Murphy, and Fernando Navajas in chapter 4. Now that the region has made progress in overcoming the problem of secular fiscal deficits that was so troubling in the 1980s, attention needs to turn to another of the traditional roles of public finance that was ill served in Latin America in the past: that of stabilizing the macroeconomy over the business cycle. López Murphy and his colleagues explain the procyclicality of fiscal policy in political-economy terms as an equilibrium between political pressures to increase spending during booms and the response of an executive branch concerned with deficits and distortions that gets leverage only in bad times.

Their prescription includes more transparency regarding hidden debts and tax expenditures and rules analogous to the European Union's Maastricht criteria—though both more stringent and more sophisticated—to govern the reaction of expenditure and debt policies to exogenous shocks. The greater sophistication is required because the Maastricht criteria actually curb the ability to pursue anticyclical fiscal policies, whereas a major objective of fiscal rules in Latin America should be to promote anticyclical policies. These will have to start by restraining the temptation to splurge in the good times[8] (it is no good criticizing the IMF for pressing fiscal austerity on Argentina in 2002; the only way of financing fiscal relaxation would be by inflating, and that would certainly not benefit poor people).

Another area needing attention in a number of countries is reconciling the new and welcome measures of fiscal decentralization with the maintenance of overall national fiscal discipline. This again needs the design and acceptance of rules, in this case rules designed to confront subnational governments with hard budget constraints without depriving them

7. This is not to suggest that any property grab should be subsequently ratified by the state; that would make a mockery of the very concept of property rights. Nonetheless, there are large extralegal settlements in most Latin American countries where the former owners have long ago abandoned any attempt to exercise property rights but the current de facto owners are denied the advantages that come with legalization.

8. Note that this is what Chile did in the early 1990s (in part by imposing the *encaje*). Its reward was to be the fastest-growing Latin American country, and one of the few to avoid a major macroeconomic crisis, during the decade that followed. Similarly, Colombia stood out as the country that followed anticyclical policies in the 1970s, and it too was rewarded with the region's best growth performance in the 1980s.

of the autonomy that will allow them to act on the basis of regional or local preferences. That means that they need a substantial tax base of their own on which they can levy regional or local taxes to reflect regional or local priorities. The obvious tax to employ is a property tax, which is fairly progressive and systematically underutilized in the region. The chapter also argues that transfers from central to regional or local governments should be based on a formula related to the *expenditures* (rather than the *revenue*) of the central government, so as to avoid a national anticyclical policy being undermined by variations in regional or local spending.

Although fiscal deficits are not the drag on national savings that they used to be, the change has not been sufficiently pronounced to make the budget a big contributor to savings. In addition to pushing fiscal reform further, there is a need for a financial system that is capable of mobilizing private savings and intermediating them to where they will be invested productively. That is not the case at present, as Pedro-Pablo Kuczynski explains in chapter 5, as a result of which the region is excessively dependent on capital inflows, which helps explain its vulnerability to financial crises.

Firms declare that by far the most important obstacle to their development is a lack of finance, which is manifest in both the difficulty in raising equity finance and the very low gearing ratio of Latin American firms (35 percent on average, less than half the average in South East Asia and a third that in the average industrial country; IDB 2001c). Banking systems continue to have a high proportion of nonperforming loans, limited coverage, too many inefficient state banks, and little medium-term lending. Bond markets have improved but remain weak, whereas mortgage markets are virtually nonexistent outside Chile. After briefly flourishing in the first half of the 1990s, equity markets have once again gone to ground. The most hopeful financial development of the past decade is the growth of private pension funds, which were pioneered by Chile and have since been copied in a number of countries.

The challenge now is to implement a range of "second-generation reforms" needed to enable the capital markets and the banks to fill the void that will be left if capital inflows never revive—as they may not, given that the international banks are still feeling burned, the surge in foreign direct investment associated with privatization has largely run its course, and the shine has gone off emerging markets among international investors. The rather unglamorous but very necessary reforms needed to build domestic bond markets include improving the legal protection of creditors by facilitating prompt recovery of assets pledged as collateral in the event of default; developing credit registries; privatizing state banks; upgrading accounting standards; providing a level playing field on regulatory and tax issues; and creating a benchmark government bond. Kuczynski argues that reviving equity markets will mainly depend upon a change in the present unfavorable market perceptions of growth prospects in Latin America but could usefully be aided by greater transparency and a strengthening of the rights of minority investors.

Even if large-scale capital inflows do not revive, it would be a mistake to suppose that Latin America will in the future regain the insulation from the international capital market of the earlier postwar period. Barring strong and costly, perhaps prohibitively costly, policy actions to close the capital account, exchange rate policy will in the future have to be conducted on the assumption of capital mobility. In fact, the speculative crises spawned by capital mobility have already led to a big change in the exchange rate policies employed in the region, away from temporarily fixed rates and the varieties of crawling band that were widely employed in the past toward the "two-corner solution." One of the corners is a fixed exchange rate backed up by institutional measures to create confidence that its fixity will be sustained, which advocates used to assume could be provided by a currency board (as in Argentina), but now look to dollarization to provide (as in Ecuador and El Salvador). The other corner is a floating exchange rate, with the nominal anchor being provided by inflation targeting (as in Brazil, Chile, and Mexico).

But questions still abound about whether this two-corner solution is going to provide a lasting resolution to the crises that have dogged the region in the past. Does Argentina's experience not demonstrate that a hard peg may impose costs even greater than those of classic currency crises? Are the countries that claim to be floating allowing their exchange rates to move freely, or do their actions demonstrate a "fear of floating"? Is it true that no principles of exchange rate management can be devised that will improve on the behavior of a floating rate?

Liliana Rojas-Suarez argues in chapter 6 that the best answer for the larger countries (though not necessarily for the small countries of Central America and the Caribbean, where dollarization may be appropriate if it is politically acceptable) is likely to involve inflation targeting with a floating exchange rate qualified by clear and limited rules for foreign exchange intervention.[9] But even this regime cannot be expected to work satisfactorily unless it is accompanied by complementary institutional innovations. Banks must be required to internalize the risks that they take in accepting foreign exchange exposure or lending in dollars to the nontradable sector, perhaps by requiring them to insure such risks. Shocks need to be countered, both by an ability to adjust the exchange rate and by building up and running down reserves and stabilization funds. The operation of such stabilization funds should be guided by public and transparent information on what is considered "normal."

9. There is a difference of view between Liliana Rojas-Suarez and the author of this chapter about the form that such rules should take. She favors intervention directed toward liquidity management, and with no concern for the level of the rate, whereas I favor an attempt to guide markets by indicating what rate is believed consistent with the fundamentals, with intervention directed to the objective of limiting deviations from that rate ("misalignments").

Chapter 7, on trade, by Roberto Bouzas and Saúl Keifman, describes both the process of trade liberalization in the region during the past decade and its consequences. One consequence they note is that import growth has vastly outpaced export growth, which on average accelerated very little in volume terms from the previous two decades. There were two major reasons for this. One was the limited gains in market access to countries belonging to the Organization for Economic Cooperation and Development (OECD) achieved by most Latin American countries, except for Mexico and those of Central America, as a result of which there was a minimal shift in the composition of trade from primary commodities to manufactures. The other was the widespread real appreciation of Latin American currencies in the 1990s.

Although some recovery from the depreciated rates of the crisis years was to be expected, in many cases real appreciation went much further than was desirable, particularly in countries that used the exchange rate as a nominal anchor to reduce inflation, but even in those such as Chile and Colombia that tried to resist appreciation by imposing an *encaje* on capital inflows. More competitive exchange rates are going to be imperative in the future if the region is to reap less unbalanced, and therefore greater, benefits from liberal trade. Given what was just said about the limited possibility of administrative management of the exchange rate in the brave new world of capital mobility, this implies that the fiscal-monetary mix will need to be chosen with a view to keeping the exchange rate competitive, which reinforces the earlier call for budget surpluses on average over the cycle and a better framework for mobilizing private savings. The dramatic turnaround in the Brazilian trade balance, including a year-on-year increase in exports of more than 20 percent as this is written in late 2002, shows how crucial it is to have a competitive exchange rate in order to expand exports.

Another consequence of trade liberalization noted by Bouzas and Keifman is that it did not have the effects on employment and real wages that had been predicted. These expectations were based on a simple two-factor model in which developing countries are all assumed to be labor-abundant so that free trade will raise the demand for labor and therefore employment and the wage rate. It transpires that the abundant factor in most Latin American countries is natural resources rather than labor, so that the impact on wages and income distribution is ambiguous.

This is something that should have been appreciated sooner. It implies that it would be a mistake to treat further trade liberalization as a reliable weapon for overcoming the region's inherited inequality.[10] It is perfectly

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10. It still seems even more implausible to imagine that trade restrictions can be used as a weapon for systematically improving income distribution. Table 3.3 in this volume suggests that the impact of trade liberalization on income distribution was minor (not significant), though the point estimate is that it was helpful rather than harmful. However, Stallings and Peres (2000, chap. 6) and Morley (2001) both find a small negative effect.

reasonable to seek further trade liberalization on efficiency grounds; the point is that this one stone cannot be relied on to kill two birds. The big issue is what strategy should be adopted to liberalize trade: unilateral, multilateral through the World Trade Organization (WTO), minilateral (through a Free Trade Area of the Americas, or FTAA), regional, multiple bilateral (i.e., by signing as many bilateral free trade agreements as possible), or all of the foregoing?

Because unilateral liberalization has now largely run its course in the region, there is certainly a need to exploit multilateral, minilateral, and regional possibilities, and doubtless the bilateral route will continue further for some time yet. The minilateral—FTAA—route seems particularly promising in the Latin American context.[11] Allied with competitive exchange rates and the sort of measures to improve competitiveness that Bouzas and Keifman advocate, the result should be much greater export increases and substantially lower trade deficits than the region experienced in the 1990s, thus enabling it to grow without the need for large capital inflows.

A country that is lucky enough to have natural resources would be foolish not to take advantage of them. Nonetheless, if Latin Americans are to be more than hewers of wood and drawers of water, they will need to be able to command the tools of the knowledge economy. This means that they will need to overcome the longstanding weakness of the region in providing education to its children,[12] and to move progressively toward the lifetime learning that is fast becoming the norm for a large proportion of the labor force in the more technologically advanced societies. Chapter 8, by Laurence Wolff and Claudio de Moura Castro, surveys the present weaknesses in the region, but notes also the signs of recent progress. A variety of approaches will be necessary to extend these further. More money is an essential condition for further advances; good education does not come cheap. But simply throwing more money at education is not enough. The money needs to be spent by what the chapter's authors call a smart state: one that will promote decentralization, exploit testing, foster parental involvement, use technology in teaching, and constantly experiment.

Public funding needs to be redeployed down from the universities toward the primary and increasingly the secondary level, which is as far as the bulk of the population gets. That is not to call for curtailing university spending, which is going to be key to the technological upgrading that

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11. Unfortunately, the US insistence on including a clause emasculating their right to use well-designed measures to influence capital flows in the bilateral free trade agreements it negotiated with Chile and Singapore suggests that it may try to include something similar in an FTAA. That could go a long way to negating the trade benefits that Latin America can expect from an FTAA.

12. Fernandez-Arias and Montiel (1997, table 3) attribute about 0.5 percent of the lag of Latin America's growth rate behind East Asia's to the education lag.

will allow the region to retain its place as the most advanced of the developing regions of the world. Rather, it calls for cost recovery, by expecting students to pay a substantial part of the cost of their university education. By all means provide student loans practically on demand and scholarships to the truly needy, but middle-class students who riot against being charged for access to a lifetime of privilege are the true enemies of an assault on inequality, and they need to be told so.

The field in which there has been the least progress in implementing liberalizing reforms is without much question the labor market. Roughly half of the labor force in most countries had the good fortune to get jobs in the formal labor market while economies were rapidly expanding. They tried to give themselves a high degree of protection through labor market legislation, although this has come under pressure as a result of the liberalizing reforms of the past decade. But the principal problem is that their benefits come at the cost of closing the door to others. This presents a major challenge in designing a reform program that will not unduly encroach on the acquired rights of the incumbents but will nevertheless break down the barriers that prevent so many of those in the informal economy from aspiring to anything better.

The challenge of designing such a program is taken up by Jaime Saavedra in chapter 9. He points to the need to reduce severance payments, because they constitute contingent claims on companies that tend to be exercised at the time a company can least afford to pay them, and thus constitute an important disincentive to hiring in the formal sector. He suggests replacing them by a system of individual accounts (as in Colombia) so as to make the burden of providing a measure of income security to workers more predictable and to spread the cost out over time. And he notes the benefit of tying pension benefits to contributions, so that workers are less likely to regard that part of their social security payment as a tax.

Saavedra urges unions to recognize that their interests are not always antagonistic to those of the employers, but that both share important common interests in raising productivity so as to permit companies to pay high real wages and provide generous nonwage benefits. He points to the benefits of improved labor market information, skill certification, and occupational training systems, so as to improve the ability of the labor market to match demand and supply.

Chapter 10, by Patricio Navia and Andrés Velasco, deals with the political economy of reform, and specifically the political problems of achieving implementation of second-generation reforms. The political problem of achieving economic reform was characterized by Haggard and Williamson (in Williamson 1994, 531) as gaining acceptance of changes that promise benefits that may be large but are long term, diffuse, and with unknown beneficiaries while the costs are immediate, concentrated, and readily evident to those who will lose. Navia and Velasco argue that this tends to be far more true of second-generation reforms than of most first-generation reforms: “the set of interests potentially affected in the [second] stage reads like a *Who’s Who* of highly organized and vocal groups: teachers’ and judicial unions, the upper echelons of the public bureaucracy, state and local governments, owners and managers of private monopolies, and the medical establishment.” Many of the reforms recommended in this volume fall into the category they are describing, so their light on how to win political acceptance for this agenda is much needed.

They do not give much credence to some of the standard prescriptions for reform. Crises may help induce reform, but the empirical evidence does not assign them a major role, and in any event going out to stir up crises so as to nurture support for reform hardly sounds like a promising strategy. Bundling reforms into big bangs may be sensible where the political conditions to permit bundling are present, but we need to learn how to make reforms where they are not. Reform by stealth—policy reversals—has become far less common in recent years than it was a decade ago.

They regard a more promising avenue as exploiting the political uncertainty that forces politicians to look beyond their traditional constituencies to a more fluid electorate that votes on the basis of perceived results. A legislature composed of career professionals who are dependent on their constituents rather than their party improves the chance that legislators will perceive political benefits in strong economic performance. If election is by proportional representation, the electoral district should be of modest size (something like five representatives), to limit party fragmentation. Election dates should be consolidated, to avoid the phenomenon of the permanent election campaign. A reform-minded government should exploit its honeymoon—and it should keep a drawer of reform plans ready to launch whenever political circumstances appear favorable.

Finally, Navia and Velasco argue that presidents should not invest their own political capital too heavily in pushing reform, which should instead be led by those who can be politically sacrificed without fatally damaging the administration for which they work should a particular reform fail to win acceptance. Obviously there is no panacea on offer here, just some guidance on how to begin to think about exploiting the opportunities offered by the democratic environment that the region now boasts.

Supplementing the Agenda

No book of reasonable length can expect to contain a full treatment of every topic that is important to the future development of Latin America. Let me therefore try to compensate somewhat by a brief consideration of five crucial issues that were not treated in individual chapters: democracy, social progress, illegal drugs, the environment, and the policies of the rest of the world.

Latin America, like Europe, is now almost universally democratic. Both regions now have only one regime that cannot claim democratic legitimacy with reasonable plausibility. It is true that much of the fervor that accompanied the revival or initiation of democracy has ebbed as democratic regimes have shown themselves just as vulnerable to corruption and just as capable of economic failure as those they replaced. Nevertheless, the whole mindset of what is a normal and acceptable form of government in Latin America, and what sort of actions would trigger hostile reactions by neighboring countries, has been transformed since the authoritarian epoch of the 1960s and 1970s. Democracy has ridden out the debt crisis and the adoption of market economics, despite the warnings of the Jeremiahs that it would perish if subjected to such stresses. Today no one believes that only authoritarian regimes are capable of introducing market-oriented economic reforms or stabilizing inflation. If there were a decade of decent economic progress comparable to that which Chile achieved in the 1990s, Latin America could be expected to emerge with democracy as securely entrenched as it is in North America or in Western Europe.

Perhaps surprisingly, given the facts about income distribution that have already been alluded to, Latin America on average seems to have somewhat better social indicators than would be expected given its level of per capita income. At least, more countries rank higher on the human development index than in terms of per capita income (21 countries higher and 10 lower, according to table 1 of the appendix to the 2002 UN *Human Development Report*). Comparing the figures for 2000 in the 2002 *Human Development Report* with those for 1990 in the 1991 report, one finds that life expectancy increased by just over 2 years to 70 years (as against 78.2 years in the high-income OECD countries), adult literacy increased from 84.0 to 88.3 percent, and, rather impressively, mortality for children under 5 years of age almost halved, from 65 to 37 per thousand (though that is still a lot higher than the 6 per thousand in the OECD countries).[13]

Latin America is still ahead of East Asia in both longevity and literacy, although the gap is much smaller than that in per capita income, but at least the region's poor income distribution does not completely nullify the advantage that one would expect it to gain from its higher income level. Faster economic growth concentrated disproportionately on those lower down the income distribution, the objective of the policy agenda developed in this book, can be expected to improve the social indicators further. Progress could be accelerated even more by an increased focus of public expenditures on the social sectors, although this should of course be accompanied by concern for the quality of expenditures (which may again need a second-generation reform program).

13. These figures are all unweighted country averages.

One of the great unmentionable topics in discussions of economic policy in Latin America is the illegal drug problem. It is time to recognize that this is in fact a critically important issue for a number of Latin American countries, namely those whose climate and geography give them the ability to produce marijuana and cocaine, meaning Bolivia, Ecuador, Peru, and above all Colombia. If these products were traded legally, their production would provide a modest income for a significant number of peasants and their commercialization would also generate a number of jobs, but there would be no large profits in the business because competition would keep prices close to the cost of production. But countries outside the producing region have decided to combat consumption through prohibition and have enlisted the producing countries in an effort to suppress production and trade. Because demand is highly inelastic, this attempted suppression results in high prices, and therefore tempts producers and traders into taking risks, for which they as individuals, but not the societies of which they are a part, get handsomely rewarded.

The war between those involved in the drug trade and the governments that try to suppress it results not just in the brutalization of society, but also in economic costs that surely outweigh the economic benefits of drug production. It is difficult to see how this will ever change except by some form of legalization in the drug-consuming countries, which is a topic well beyond the scope of this study.[14] That leaves a large cloud hanging indefinitely over a significant part of Latin America.

The source of the rich natural resource endowment of the region noted above is its unique natural environment, involving inter alia one of the two great mountain chains of the world, the world's largest tropical rain forest, its deepest topsoil, and its tallest and most beautiful waterfalls. Biologists and all those with any aesthetic sense worry about the possible loss of this inheritance. The person in the street is perhaps even more concerned about local environmental ills, such as the air and water pollution that are prevalent particularly in low-income urban areas. (And the region is now overwhelmingly urban; 74 percent of its people lived in urban areas in 1997, as against 78 percent in high-income countries, far higher than in other regions of the developing world.)

These local environmental problems have begun to receive attention, and some places—like Cubatão in Brazil, which was in the 1970s reputed to be the most polluted place on earth—have already been transformed for the better. The slowdown in population growth, which is now down to 1.6 percent a year as a result of declining fertility (which is forecast to reach replacement level within about 20 years), also gives hope that local environmental problems may be on the road to solution.

14. But let us just note that, if demand really is highly inelastic, then the price fall resultant from legalization would not stimulate a large increase in demand. Or are we supposed to believe in a kinked demand curve?

The big outstanding questions concern *global* environmental issues. The region is a small player in carbon emissions, but a major one in biodiversity. Many of the logging companies continue to despoil the continent's forests, an action that in the future will surely win them the same revulsion that in our generation we feel toward the slave ship captains of old. If this were a case of making environmental issues take a back seat until living standards had risen, because of an environment-growth trade-off, tolerating the destruction of the forests would be sad but perhaps understandable. However, the evidence suggests that allowing uncontrolled logging is a lose-lose policy from a social standpoint, with the logging companies and those they may need to bribe to get access to the forests as the only gainers.

This study has focused on what Latin America can do for itself. That does not mean that we believe that its future is independent of what happens in the rest of the world. Although in the long run a country's fate is primarily dependent on its own choices, in the short run the progress of any region is closely bound up with what happens in the outside world. Latin America clearly has an interest in the industrial countries' avoiding recessions, and in their allowing access to their markets for the goods in which the region has a comparative advantage, especially agricultural products. Latin America would surely benefit if the industrial countries were to agree to a renegotiation of the intellectual property rights provisions in the WTO, to give more weight to the aim of achieving rapid and cheap diffusion of inventions and less to maximizing the rewards for inventing.

The region would certainly benefit if the recent phobia against emerging markets in industrial-country capital markets were to be replaced by a more balanced view. Latin America would stand to gain if international measures were taken to improve protection against such exogenous shocks as sudden falls in commodity prices (e.g., by strengthening the IMF's Compensatory Financing Facility). It will need help, in terms of a willingness in the industrial countries to sign tax information-sharing agreements, if it is ever to collect income tax on the bulk of the income earned on flight capital.

Latin America could also hope to benefit if the international community were to decide that it was prepared to pay for global public goods like the preservation of biodiversity, and it decided to raise real money to pay countries for safeguarding such global treasures as tropical forests. And a few countries (mainly the poor ones, notably Bolivia, Haiti, Honduras, and Nicaragua) will benefit if foreign aid programs are rebuilt in pursuit of the UN Millennium Development Goals. So there is much that the international community could do to help the region, only a small part of which could be described as charity. But regardless of the extent to which the rest of the world helps, Latin America will help itself by implementing the agenda laid out above.

Concluding Comments

Thirteen years ago, I summarized the "first-generation" policy reforms that were then being implemented in many Latin American countries in 10 pithy points, which I termed the Washington Consensus (see the discussion in the appendix). There is significant overlap between that list and the agenda laid out above. Fiscal discipline is still not completely secure. Many countries still need tax reforms to broaden the revenue base and cut marginal tax rates, and better tax administration to make tax yields more progressive without reverting to prohibitive marginal rates. Public expenditures still need to be redirected, away from indiscriminate subsidies and toward productive social spending like health and education. There is still useful scope for further liberalizing trade. It is as important now as it was then that exchange rates should be competitive. Privatization still needs to be pushed further, especially regarding state banks. Creating new enterprises, or at least incorporating them into the formal sector, is still impeded by a raft of pointless regulations. There is still much to be done to register the property rights of those in the informal sector.

At the same time, the overlap is far from complete. Some of the reforms that then seemed important—such as allowing foreign direct investment to enter or liberalizing interest rates—have been accomplished. Other things have come onto the agenda, such as empowering the poor to contribute to (and thus benefit from) economic growth, or the focus on crisis proofing the economy. There are two quite distinct reasons for those changes that have occurred. One is that time has progressed, and what was relevant then may not be so now, while both research and the march of events have resulted in new reforms being perceived as urgent. The other reason is that the original list represented an attempt to distill a consensus among third parties, whereas the agenda presented above consists of the reforms that the authors of this book believe are needed. Our agenda can be summarized under four headings:

- ***Crisis proofing***. This can be furthered by anticyclical fiscal policies, hard budget constraints on subnational governments, stabilization funds, flexible exchange rates,[15] inflation targeting, further strengthening of fiscal positions and completion of pension reform so as to reduce dependence on foreign savings, and regional peer monitoring of Maastricht-like commitments to fiscal responsibility.
- ***Completion of first-generation reforms***. It is important to liberalize the labor market so as to give those currently in the informal sector the opportunities that come only with formality; we believe this should be sought by cooperation rather than confrontation. The labor market

15. Except where the economy is so dominated by the United States as to make dollarization an economically viable option.

could also be made more flexible through a comprehensive program of labor retraining. Trade reforms need to focus primarily on improving market access to industrial countries, via the FTAA and WTO. There are still many enterprises, including state-owned banks, to be privatized.

- ***Aggressive second-generation (institutional) reforms***. Needs differ by country, and we have not developed this agendum with the same detail as elsewhere, but leading candidates include the political system, the civil service, the judiciary, and the financial sector.

- ***Income distribution and the social agenda***. Efforts should be made to make the fiscal system more progressive, not by reverting to penal marginal tax rates but by such actions as imposing property taxes and by focusing expenditures on the universal provision of high-quality basic education and health care. Poor people need to be empowered by giving them access to the assets that will enable them to earn a decent living in a market economy: education, land, credit, and titling.

It perhaps needs saying explicitly that we commend this agenda given what we know in 2002, but it is not presented as ultimate truth.

Finally, the agenda is for the medium term, rather than one addressed to resolving the short-term crises that seem likely to be again preoccupying the region when this book is published. This is deliberate. Latin America will never break out of the crisis syndrome unless it pays more attention to long-term issues, particularly but not exclusively if the good times eventually return.