Don't Blame Our *Failures* on Reforms that have *Not Taken Place*

by Francisco Gil Díaz

There is a widespread perception that market economics has been tried and failed in Latin America. This perception is wrong. Because of this, I thought it fitting to attempt a bird's eye view of the outlook for Latin America's economic policy, and consequently for the well-being of the region's population. The exercise will contrast our institutional setup with the one needed for a well performing economy.

We shall see that the policies that have been undertaken are not even a pale imitation of what market economics ought to be, if we understand market economics as the necessary institutional framework for a sound economy to operate and flourish. However, and to some degree surprisingly, television and radio commentators, assorted politicians, editorialists, and even some (mislabeled) "reputable" economists have been able to portray as the real stuff the grotesque caricature of market economics that has been implemented throughout our continent.

Is the harkening back by many populist advocates to protectionism, to state intervention, to regulation, to wasteful public expenditures, to price subsidies, to deficit spending, and to state-owned firms justified by the failure of market economics as they often successfully argue? Because of the importance of this issue for the future of millions of downtrodden fellow Latin Americans, it is imperative to stop and consider if what has transpired is really an experiment with free markets. Or is it the opposite—a failure attributable to large scale intervention and, because of a few half-hearted attempts at reform, maliciously mislabeled variously as the "Washington Consensus," "economic orthodoxy," "market economics," "monetarism," or "neo liberalism"?

It would take a lot of research to explain the politics behind the policies in Latin America over the past few years. However, this discussion will be limited to what has been done and contrast that with what market-oriented economists consider the conditions essential for a well-functioning market economy.

The scope of economics

In this regard, it is pertinent to ask what the scope of economics is, and whether its analytical instruments have the wherewithal to answer some fundamental social puzzles. For the purpose at hand, the field is powerful as a forensic discipline; it has the capability to explain why economic organisms stagnate or retrogress, or conversely, why they can function efficiently and grow quickly under other, different policies. Several recent research pieces have tackled this issue and point towards the sorts of conclusions outlined below. Among them is the need for an environment that provides incentives for individual initiative and, in order to achieve it—and of the utmost empirical relevance—the existence of a reliable justice system. There are other ingredients in this recipe, but as these recent studies point out, the stew will be inedible without the judicial backbone. In this empirical and theoretical quest, Richard Roll's and John Talbott's *Why Many Developing Countries Just Aren't*, Hernando de Soto's *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*, and William Easterly's *The Elusive Quest for*

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Growth stand out. Their “contemporary discovery” would not have surprised Douglass C. North nor more recent historians, such as David S. Landes (*The Wealth and Poverty of Nations*) and Niall Ferguson (*Cash Nexus*), or, most certainly, the classical economists. Although other useful experiences abound, in Asia for example, our continent is a good laboratory to test whether the conditions for a well-functioning market economy have been set up.

Latin America’s failure

With the exception of Chile, whoever examines Latin America may be tempted to conclude that two decades have been lost; income per person for the region is no higher than it was 20 years ago. Even worse, in obvious disregard of the evidence provided by Chile, and more recently by El Salvador and Costa Rica, and by countries outside the region, the stubborn conventional wisdom remains: Latin America’s failure is the failure of market economics. Beyond criticizing the superficiality and incompleteness of this so-called consensus, the conclusions about such failure are rooted in deep biases or in plain ignorance. This is because, without delving too deeply, it is obvious that what we might label the essential prerequisites of a successful economic policy have not been met throughout the region, except, with an almost sufficient persistency and completeness, in Chile.

Do the policies that Latin America has followed comply with the conditions for a market economy to blossom? This paper makes no quantitative attempt to test a theory, but relies on common sense and theory, which should be more persuasive than econometrics based on innumerable proxies that substitute for poor information. It would be laborious to detail the policy failures in country after country, but some broad strokes ought to suffice. I will consider the following policy levers: the performance of the judicial system, free trade, private ownership of the means of production, commitment and effectiveness in the combat of monopoly power, institutional safeguards to guarantee fiscal discipline, local government empowerment and competitive federalism, the regulatory environment, especially the one related to the initiation costs of firms, and the distribution of public educational expenditures as well as their accountability.

Judicial systems

I begin with the most important item: the functioning of the judicial system. There are large differences among countries in this regard, but perhaps with the exception of Chile,[1] no country has radically reformed its judiciary. Respect of contracts, essential to the performance of a market economy, is a rarity. Judicial processes are unpredictable, riddled with corruption, long, and expensive.

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Their costs are reflected, among other effects, in high bank intermediation margins. Thus, long and unpredictable collateral recovery costs are translated into high lending rates. Excessively high lending rates discourage demand for credit, and poor credit demand is, in turn, reflected in a scant supply of deposits and of other banking services. Intermediation margins are, after all, the “price” or cost of the financial sector which, when expensive, result in a flabby banking sector. Such immature and insufficient financial sectors often mean insuperable entry barriers for small firms and a dearth of housing mortgages. A market economy is based on property rights. Therefore, low predictability about the respect for contracts contributes to a general reluctance to undertake risk, and hence to invest. If sustainable growth is the result of an environment in which people find that their efforts, their work, and their ingenuity have a good chance of being rewarded, the clue to understanding stagnation or lack of sustained growth is to be found in judicial sectors with costly, corrupt, and unreliable outcomes. Alternately, since people respond to incentives, in an environment where property rights *are* respected, millions of individual efforts will combine and emanate from firms and within firms to produce prosperity.

Free trade

Free trade is neither a sufficient nor an exclusive source of sustainable economic growth, but it has been found to be an important growth catalyst. It is evident that only a smattering of Latin American countries has opened up their economies to foreign trade. Without the discipline of foreign competition, domestic markets are often concentrated and monopolized, firms become complacent, and their production relies on old equipment, backward technologies, and indifferent managerial skills. Closed economies don’t necessarily result in zero foreign investment, but they do result in foreign firms introducing outmoded capital goods and outdated technologies. The low ratio of international trade to GDP that a closed economy entails also means a greater vulnerability to shocks. This was demonstrated dramatically by the two crises in Mexico’s economy in 1983 and 1995: after the 1983 crisis, a closed economy meant that it took 7 years for Mexico's industrial production to recover; in 1995, an open economy allowed Mexico's economy to recover in only 18 months.

Private versus public

Private firms have proved to be more efficient and nimble than government owned ones. In this sense, no country in the region has privatized nearly enough. Many chores that can be done much more efficiently by the private sector are still in the control of bureaucrats and, in some cases, burdensome and powerful unions. Income distribution, budgetary results, and management, efficiency, and investment opportunities are all adversely affected when public sector firms produce goods for the market. It is ironic that the alleged goals of public sector ownership of productive enterprises, such as national sovereignty and job protection, are often compromised because of them.

Unions are often able to obtain inflated wages from public sector firms while some corrupt officials have been able to prosper through ill-gotten gains at the expense of these firms. Moreover, public sector ownership creates the temptation, all too often accepted, to subsidize prices for political reason. All of these factors—rent-seeking unions, corrupt officials, and subsidized prices—associated with public sector firms create a fiscal drain on government. It is no wonder that public debt has accumulated and that budget management is often compromised. One glaring example is the income and expenditure savings that would have accrued if water charges reflected their opportunity cost and water were metered. In that case, Mexico would owe less than half its present public debt, and would also suffer substantially less environmental degradation than it now does.

Regional monopolies

Public firms and public monopolies are not exclusive economic drags. Beyond the conspicuous monopolies left by privatizations that did not set out clear competitive rules for incumbent firms, large pockets of regional monopolies remain that make for clumsy market performance and raise the cost of capital expenditures. Witness in this context the costs imposed by local transport unions—truck transportation is generally clustered into locally-led fiefdoms—that require, for instance, that materials for road construction be hauled from sites considerably further than needed simply to artificially raise their business volume. Local urban trucking unions impose another substantial cost that fragments transportation rather than allowing for the seamless operation of point-to-point delivery. At a more aggregate level, telecommunications density—the essence of globalization—is another regional laggard, particularly in Mexico. It should not be surprising that China has been so successful in drawing large volumes of foreign investment; among other attractions, it boasts a magnificent infrastructure and an ingrained honour system that substitutes for formal contract protection.[2]

Parliamentary budget processes

Parliamentary budget processes that impose fiscal discipline are rare. In countries that depend largely on foreign currency liabilities and scant financial intermediation, fiscal orthodoxy is essential for providing macroeconomic stability. In turn, stability is a *sine qua non* if one is to attract large and continuous flows of private investment. Stability is also necessary to prevent the burden on the poor from worsening. Most countries in the region have not carved safeguards into constitutional stone to protect them against porkbarreling, nor have they reduced their public debt to a credible, long-term-financeable size. In this context, in most countries the pension burden hovers as a heavy future tax.[3] Legislatures frequently approve programs, often with permanent expenditure commitments, that have no funding source. What is worse, critics pay lip service to the often-cited pretext for avoiding free market economics—that the market does not provide sufficient public goods. However, the goods have not been delivered. Poor, insufficient roads, creaky, slow, and outdated railroads, dismal quality and insufficient public education are hidden behind a veil of public expenditure which disguises bureaucratic outlays and is certainly not a measure of the public services provided. High expenditures are not a measure of government output.

Federalism

In countries that have imitated the American federalist mode, federalism has been interpreted not as competition amongst political units that provide bundles of taxes and public services to those who wish to establish themselves or their firms within, but rather as a battle cry to milk the federal treasury to avoid the political cost of local taxation. This has translated into a worrisome tendency to progressively weaken federal finances. There is a moral hazard here of troubling proportions that bears upon the perceived solvency and liquidity risk of sovereign debt, to which the Argentinean experience can attest. Evidently these fiscal commitments add to the budget, to country risk, to the cost of debt, and hence depress investment opportunities.

Education

Education is generally poor—not necessarily poorly funded—as evidenced by Mexico's well provided for but inefficient educational system. Under such circumstances, indigenous growth crucially depends on a boost from foreign investment, which typically comes with on-the-job training, helping to fill in the educational gaps. But modern technologies, whether in manufacturing, communications, or agriculture, necessitate at least a generalized, basic education that few countries in the region have achieved. Accountability in education is another matter. Basic public education is generally centralized, with no objective evaluation systems that stimulate individual schools to compete in quality or provide parents of prospective students with information. While it is desirable to have basic public education subsidized or paid for by the government, at least for those in need, competition among schools would obviously promote quality and choice for children. Because of political pressures, most countries have misallocated public funds by concentrating large quantities of public resources at the university level. This concentration subsidizes the middle and upper classes, to the detriment of basic education, which is most needed by the poor.

Deregulation

Deregulation has attracted much lip service, but practically no action. New business units take many months to create—sometimes more than a year of paperwork—as well as requiring high outlays for several layers of petty corruption. The latter is so widespread that it is considered a normal and acceptable cost of doing business. Obviously, corruption costs represent an additional barrier for small- and medium-sized firms; they also encourage businesses to produce outside the formal sector where taxes are scant and there are no social security contributions.

An epidemic of crises

Growth has also been hampered by an epidemic of crises over this period. The crises are induced by the attraction of short-term capital flows, which in turn are induced by the one-sided bets of fixed exchange rates. These crises have shocked the region intermittently over the past 20 years and contributed to deep and substantial growth interruptions. Free capital movements and flexible exchange rates are coming into their own but have not been in place long enough to nurture the expectation of permanence.

I have attempted to provide a checklist of the conditions that markets need in order to function properly—in other words, the institutional structures that create the appropriate market-oriented incentives for individual effort. After viewing this checklist, anybody who asserts that Latin America has been under a neo-liberal mantle—and therefore that neo-liberalism, or market economics, has failed—is either ignorant (ignorant of the facts, or ignorant of the institutional setup needed for the model to function), or is simply hostile to market economics and opines dishonestly. In fact, the lack of growth is no puzzle at all. Rather, the mystery is how, despite so many policy omissions and mistakes, the region has not seen further declines. Maybe the answer lies in the partial market reforms that have been implemented. Viewed in this context, such reforms have been wildly successful.

Does this bad news necessarily lead to a nihilistic conclusion? Given the dismal results of the truly consistent populist policies applied by some Latin American countries, I don't think so. Those experiences have provided stark evidence of the true fruits of populism. But the fact that we have not engaged in more populist experiments is no consolation. The sad truth is that Latin America has a huge potential that it has not been able to achieve. There are millions among our destitute masses who could have had a much better material well being, whose opportunities will simply not materialize under present policies. A well-functioning and complete institutional setup that allows a market economy to achieve its full efficiency and growth potential is not an end. It is a means. It has been proven time and again that if we are unable to overcome the formidable obstacles continuously set up by vested interests, growth, employment, wages, welfare in general, we will be operating below our potential. In such circumstances, as experience has shown, the poor always get the worse end of the deal.

The many obstacles we must overcome should not discourage us; research from the authors quoted above suggests that of the several issues we have gone over, two stand out as critical: judicial processes and macroeconomic stability. Perhaps it would be worthwhile for Latin America to begin by concentrating political reform capital on these two, before tackling the rest.

Notes

[1] Colombia has made significant strides in judicial reform, but with scant results, according to Brent Barton.

[2] According to a comment by Gregory Chow at Arnold Harberger's 50th anniversary celebration.

[3] Many countries have followed Chile creating funded pension systems, but these reforms are relatively late, so that a substantial overhang of previously awarded pensions remains.

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Software Comes to the Research Party

by Neil Emerick

For the greater part of the nineteenth and twentieth centuries, the debate about the best way to achieve economic growth has been a bipartisan affair, with camps split between those who opted for political intervention and those who believed in free markets. Up to this point the debate has centred on ideological arguments, yet increasingly the evidence suggests that it is the free market advocates who are right.

"If you can't measure it, you can't manage it" is a maxim widely applied in business, and one that is increasingly relevant to the science of economics. Certainly, it is important to ensure the "intervention versus free markets" argument is debated with objective facts. Measuring degrees of economic freedom in order to correlate it with growth is an important step forward in measuring these facts. Countries and their experimental mix of policies can then be compared objectively to one another along with the economic outcomes achieved.

A key contributor to the debate is the *Economic Freedom of the World* (EFW) report, published annually by The Fraser Institute. The publication contains a comprehensive measurement of legal impediments to economic freedom—sampled across 123 countries—which helps provide a foundation for research into economic freedom. The index measures 50 parameters[1] of economic freedom in a country, applying a score from 0 to 10. It includes areas such as the percentage of consumption in an economy by government, the freedom to trade with foreigners, inflation variables, and the regulation of business and labour practices. Now in its seventh year, the report has become an important tool for economists and advocates of economic freedom, helping them monitor the performance of their governments and the policies that affect their economies' natural growth.

For economic researchers, though, working with large data sets (such as the Economic Freedom of the World index) is problematic in that it is time-consuming and therefore expensive. That is why this year, Global Economic Software Ltd.—a private software development company—has created a software tool that will help economists speed up their information-gathering process and lower the overall cost of research. The product allows researchers to experiment with different theses at a high-order level before deciding whether their hypothesis is worthy of more detailed investigation.

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