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Latin America's unproductive economies

Service break

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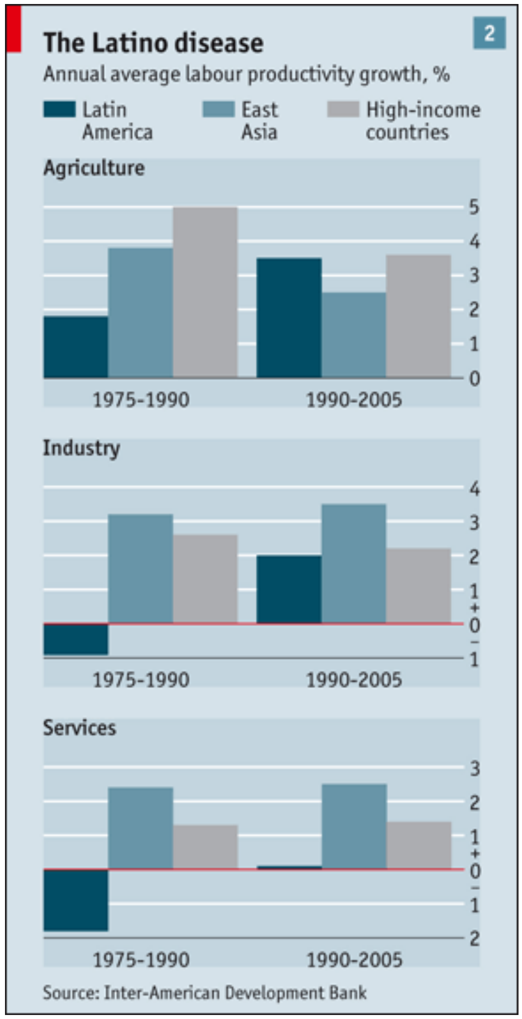
How public policies have promoted inefficiency

ITS economies may have improved recently, but much of Latin America has performed poorly over the past two generations. The gap in income per head between the region and developed countries has widened since 1960, while many east Asian countries that were poorer have leapfrogged ahead. The root cause has been Latin America's slow—or even negative—growth in productivity, according to a new study by economists at the Inter-American Development Bank*.

Productivity growth—gains in the efficiency with which capital, labour and technology are used in an economy—is the elusive holy grail of economic development. It is true that most Latin American countries have not invested enough, or provided their people with a good enough education (though both these things are improving). But productivity growth means squeezing more output from the same inputs. And Latin America has been particularly bad at this (see chart 1). Why?

The short answer is that the typical Latin American firm is a small, inefficient service business and may well be operating in the informal economy. Productivity growth tends to be higher in manufacturing and agriculture than in services (see chart 2). It also tends to be higher in large firms which benefit from economies of scale. And it is much higher in formal businesses, which can invest in innovation.



However, Latin American manufacturers are also much less productive than they might be. This is partly because clogged, inefficiently run ports, airports and other transport systems make freight costs unduly high—for example, it shockingly costs more to get goods to the United States from most Latin American countries than it does from distant China or Europe.

But 60% of Latin Americans work in service firms. Many of these businesses are held back by lack of credit and by public policies that give them little or no incentive to become bigger or to operate legally. Latin American tax codes are inordinately complicated: it takes an average of 320 hours per year for a firm in the region to file its tax paperwork, compared with 177 hours in rich countries. The IDB found that a disproportionate share of tax is paid by big companies. Simplified tax regimes for small companies have been set up in 13 of the 17 countries the bank studied. Perversely, that encourages them to remain small.

Only one in three Latin American workers is covered by social-security systems financed by payroll taxes. Governments have responded to this inequity by creating non-contributory pensions and other social programmes. As an unintended consequence, that means there is little incentive to leave the informal economy.

But not all is gloomy. In Chile productivity growth since 1960 has outpaced that in the United States. And since 2006 there has been "an upward blip" in productivity growth in the region as a whole, says Carmen Pagés, who co-ordinated the study. This has gone hand in hand with faster economic growth and an expansion of credit. Productivity growth in Brazil has surged recently: after being negative in the late 1990s, it rose to over 2% in 2007 and 2008 according to the Central Bank.

When economists say that productivity growth is the root cause of development they are almost stating a truism. From the late-1970s to the early 2000s Latin America suffered a macroeconomic slump, accompanied by high inflation and the destruction of credit. Political instability—and expropriations of businesses—in some countries also discouraged firms from growing. It is hardly surprising that productivity suffered.

The achievement of economic and financial stability in the past few years has in turn seen productivity growth rise. The IDB's study shows that it could rise faster still, boosting incomes, if the politicians take productivity into account when they draw up tax, social and public-investment policies. And the economic weight of services means it is not enough for the region to talk only about export competitiveness. Productivity begins at home.

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* The Age of Productivity: Transforming Economies from the Bottom Up, edited by Carmen Pagés, Inter-American Development Bank and Palgrave Macmillan.