Structural Reforms in Latin America: The Time is Right

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OUTLINE

I. Why structural reforms are needed?

II. What reforms can support higher living standards?

III. What considerations to keep in mind?
I. WHY REFORM? THE CHALLENGE OF LIFTING POTENTIAL GROWTH AND RAISING LIVING STANDARDS
Productivity growth has declined in developing countries...

**Total Factor Productivity Growth, 1990-2016**
*(percent, 5-year average growth rate)*

**Advanced Economies**

- 2008-09 Global Financial Crisis

**Emerging Market Economies**

- All
- Excl. China

**Low Income Countries**

Source: IMF SDN/17/04.
Note: Group averages include 20 largest economies of each income group, weighted using PPP-GDP.
...and is particularly low in the region

Source: Penn World Tables 9.0; IMF WEO; Dabla-Norris et al. (2016).
Note: The shaded area represents 10th and 90th percentiles.
Medium-term growth prospects for the region are weak

Source: IMF WHD REO.
Note: LAC – Latin America, EME – Emerging European Economies.
Convergence gaps in LAC remain large

Real GDP per capita (PPP)
(annual average, percent of the United States level)

Source: Dabla-Norris et al. (2016).
Note: LAC (6) – Brazil, Colombia, Chile, Mexico, Peru, Uruguay, CEE – Central and Eastern Europe, Other SA – Other South American countries.
Raising living standards is a key challenge

Note: Bubble size is in proportion to 2016 GDP in US dollars.
II. WHAT REFORMS ARE NEEDED?
What can structural reforms do?

- **Transform the structure of production**: policies to encourage accumulation of physical and human capital, and movement of resources to more productive use.
  - Infrastructure investment, liberalization of trade, development of financial markets, labor market deregulation, institutional reforms (reduce corruption and improve governance).

- **Improve allocation of resources within sectors**: policies to encourage survival and growth of more efficient firms, and allow firms to achieve appropriate economies of scale.
  - Remove distortionary tax and regulatory policies and entry/exit barriers, efficient financial intermediation, allocating resources to most efficient firms, land reforms.

- **Encourage innovation and adoption of new technologies**
  - Liberalization of FDI and trade, create incentives for investment in human capital.
1. Polices to transform structure of production
Address infrastructure gaps

**Infrastructure Index**
(7 represents the best infrastructure)

**Public Capital Stock**
(percent of GDP)


Note: LAC – Latin America and the Caribbean, EME – Emerging Market Economies.
Strengthen public investment management practices

**Strength of Public Investment Management by Institutions**

*Index: worst = 0, best = 10*

1. Fiscal Rules
2. National & Sectoral Planning
3. Central-Local Coordination
4. Management of PPPs
5. Company Regulation
6. Multiyear Budgeting
7. Budget Comprehensiveness
8. Budget Unity
9. Project Appraisal
10. Project Selection
11. Protection of Investment
12. Availability of Funding
13. Transparency of Execution
14. Project Management
15. Monitoring of Assets

Latin America and the Caribbean
Emerging Markets
Advanced Economies

Source: IMF staff calculations.
Note: Includes 25 advanced economies, 12 emerging market economies, and selected LAC (The Bahamas, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominica Republic, Ecuador, Grenada, Guatemala, Honduras, Jamaica, Mexico, Panama, Paraguay, Peru, and St. Lucia).
Further trade integration

**Weighted Average Tariff**

1. Effectively applied weighted average tariff (%): The average of tariffs weighted by their corresponding trade value figures.
2. Refers to 3-month moving average.

**Trade Openness**

(percent of GDP)

**Regional Export Shares, 2015**

(percent of total exports)

Sources: World Bank, WITS database; and IMF staff calculations.
Growth benefits from furthering trade integration are sizeable

LAC Exports Markets: Importance of Regional Trade
(Intraregional goods exports/Total goods exports)

Estimated growth benefits:
For every 10 pp increase in intraregional trade, per capita growth can increase by 32 bps.

Source: IMF Direction of Trade Statistics; IMF staff calculations.

1Percentiles are based on the world distribution.
Tackle corruption and strengthen governance

Macro-economic Effects of Corruption
(moving from the 50th to the 25th percentile of WGI CCI index)

- Negative association between corruption and growth, and other key macro variables.

- Worsening of corruption levels from 50th to 25th percentile lower GDP per capita growth by 1.5 pp (estimates range from 0.7 to 2 pp).

Source: IMF staff estimates based on panel regression estimates. Note that the results are robust to different corruption indicators, solid lines indicate the 95 percent confidence interval.
Good fiscal governance associated with perceptions of less corruption

Notes & Sources: All variables shown in these charts are residuals from regressions of each variable on the level of income per capita, so that the correlations reported are not driven by economic development.

1Open Budget Survey: information about the auditing of public accounts and its accessibility to the public across 99 countries.
2Benchmarking Public Procurement (World Bank): information about the public procurement regulatory systems across 184 countries.
3Worldwide Governance Indicator of Control of Corruption.
II. *Polices to improve allocation of resources*
Reduce resource misallocation (dispersion of productivities across firms)


Note: The figure shows the distribution for firms in the manufacturing sector for each country. More (less) efficient country is defined as a country at the 75th (25th) percentile of the distribution of resource allocation efficiency estimated using the Hsieh and Klenow (2009) methodology.
Gains from reducing resource misallocation are potentially large

Potential TFP gains from reducing resource misallocation to level of most efficient country

Estimated annual real GDP growth effects

Source: IMF staff calculation.
Note: The more intense is the color, the higher the TFP gain is.

Could add 1% to real GDP growth

Sources: IMF(2017)
Note: Figure shows medians across country groups. Estimates assume a 20 year transition period, that other sectors could achieve TFP gains similar to those estimated for the manufacturing sector, and that there are no adjustment costs.
Increase productivity of SMEs and young firms to boost aggregate productivity

- Small and young firms are generally less productive than large and mature firms.

- Share of SMEs in emerging market and developing countries is relatively high.

**Median labor productivity**

(in percent of median productivity of large firms)

- Small firms
- Medium firms


Note: cross-section data for 127 countries from 2009 to 2016. Medians are computed for country-industry pairs. Small firms have fewer than 20 employees, medium firms have between 20 and 100 employees.
Tax administration matters: lowering compliance costs helps small and young firms

Source: Dabla-Norris and others (2017).

Note: Labor productivity refers to sales divided by the number of employees. Small firms have fewer than 20 employees; young firms are less than seven years old. A higher score on the TAQI implies lower tax compliance costs. Countries with a low (high) TAQI score are those at the 25th (75th) percentile of the sample distribution. The TAQI uses country-specific information on different dimensions of tax administration that are likely to matter for tax compliance costs faced by firms, from the IMF’s Tax Administration Diagnostic Assessment Tool (TADAT). Medium-sized and large firms are those with 20 or more employees.
In many countries, firms underreport their sales.

Sales Reported for Tax Purposes as a Share of Total sales

*(median and interquartile range across country groups)*


Note: ADV = Advanced economies. EME = Emerging market economies; LIDC = Low income developing countries.
Tax evasion allows “cheats” to stay in business despite low productivity

Note: Cheats are defined as registered firms associated with reporting less than 100 percent of their sales for tax purposes. TFP was calculated at the firm-level, using the Levinsohn and Petrin (2004) method. EME = Emerging market economies; LIDC = Low income developing countries.
Stronger tax enforcement reduces prevalence of “cheats”

Effect of CIT and Tax Administration Features on the Share of Sales Reported for Tax Purposes by Small Firms (percent)

Note: Effect for every percentage point of CIT.
Strengthen tax administration to level the playing field

- Lower tax compliance costs
- Strengthen tax enforcement
III. WHAT CONSIDERATIONS TO KEEP IN MIND IN FORMULATING REFORM POLICIES?
Considerations for implementing structural reforms

Structural performance and policy gaps

Macroeconomic environment: income level and cyclical position

Macroeconomic policy space

Interlinkage between structural reforms and demand policies

Formulation of structural policies
Additional considerations: explore benefits and costs

Identify structural gaps and impact of specific types of reforms

Prioritize reform areas leading to faster convergence

- Implementation capacity
- Political economy considerations
- Financing on appropriate terms
- Identifying the right specific actions

Conditions for success
THANK YOU