Structural Reforms in Latin America: The Time is Right

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OUTLINE

I. Why structural reforms are needed?

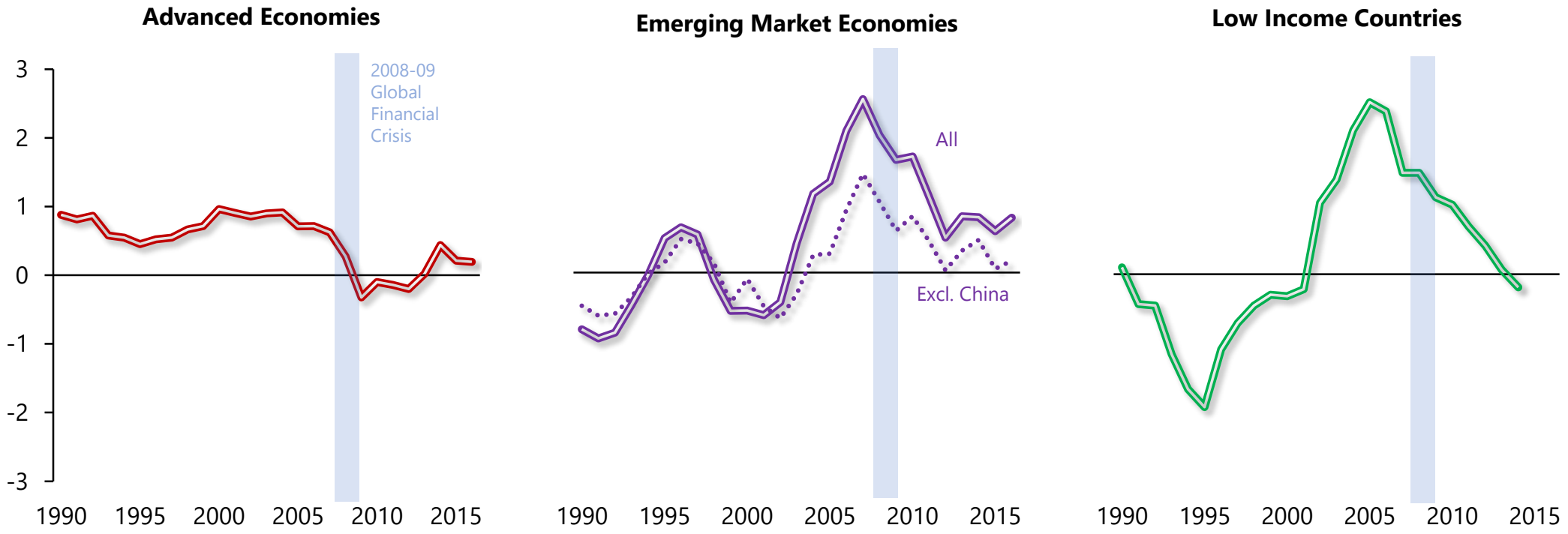
II. What reforms can support higher living standards?

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…

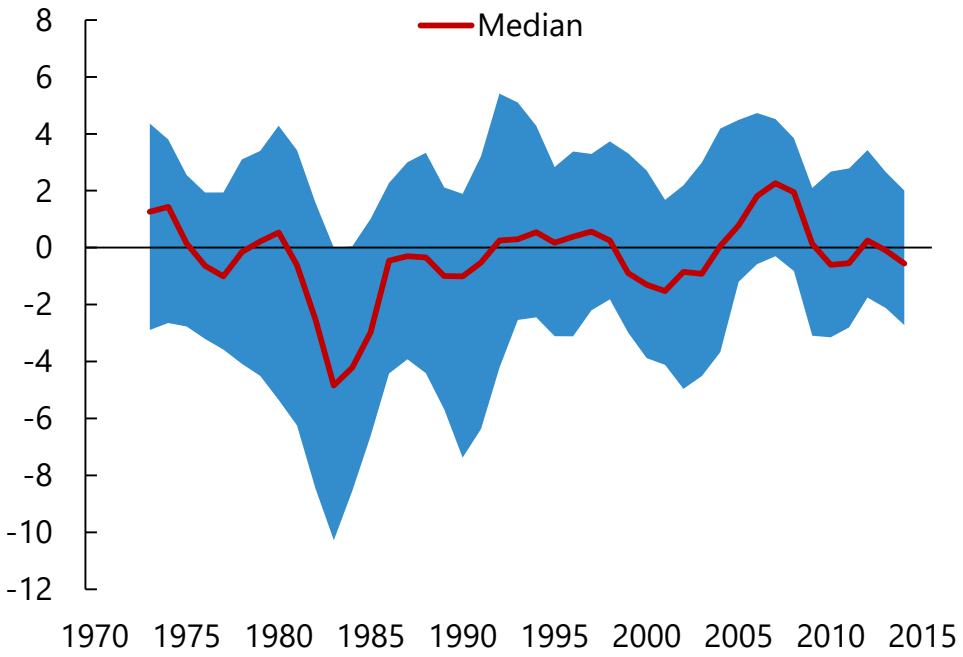
Total Factor Productivity Growth, 1990-2016
(percent, 5-year average growth rate)



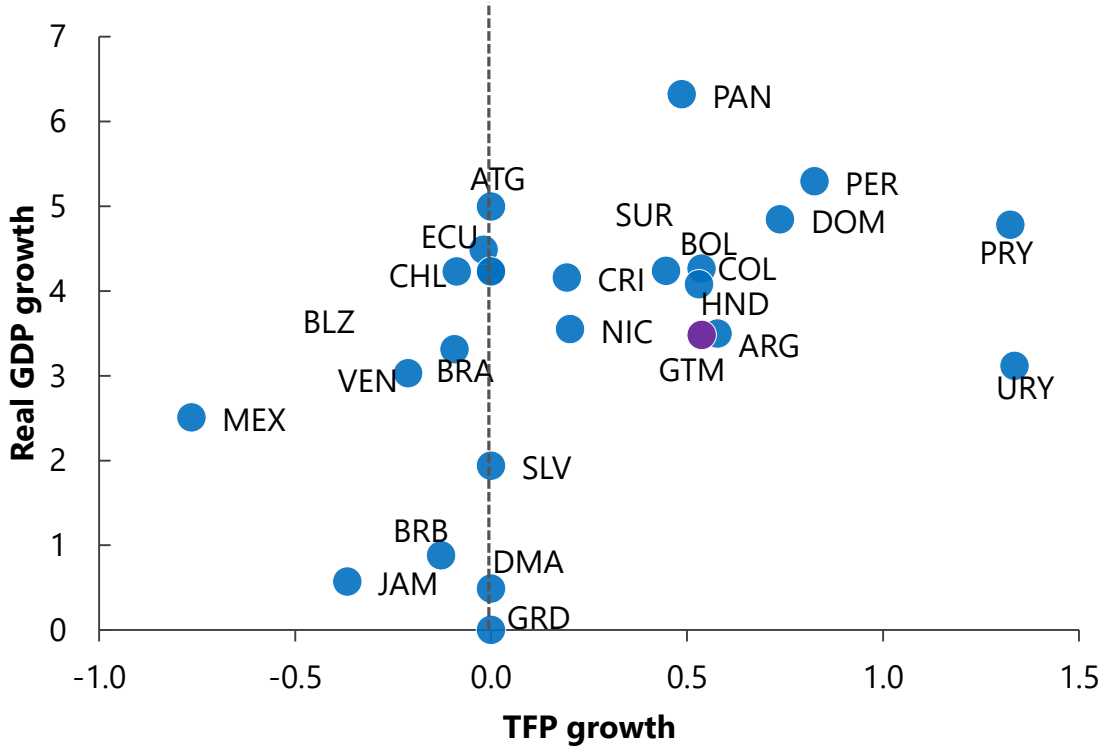
Source: IMF SDN/17/04.
Note: Group averages include 20 largest economies of each income group, weighted using PPP-GDP.

…and is particularly low in the region

TFP growth in Latin America
(percent, 3-year moving average, 1970-2015)

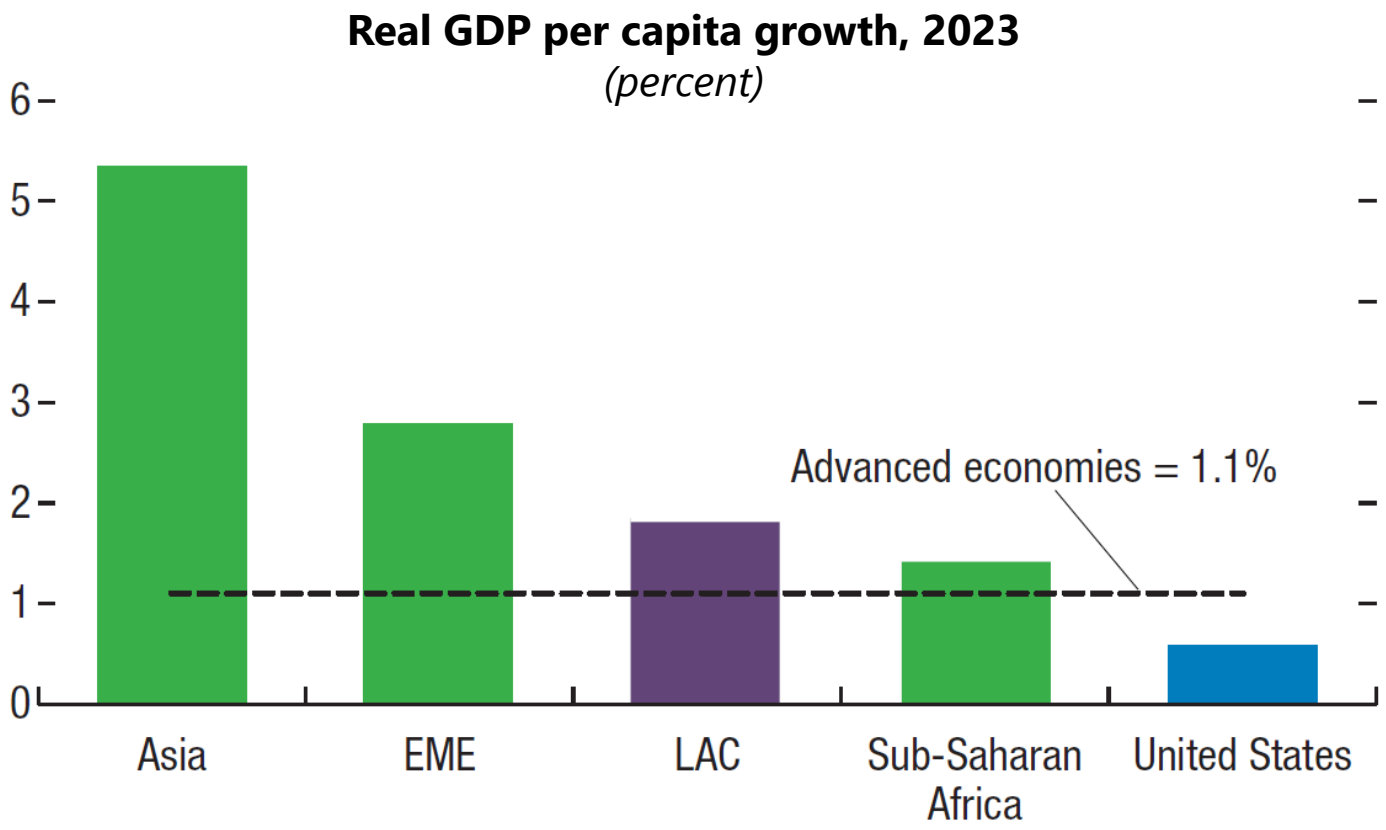


Average TFP Growth and Real GDP Growth
(percent, 2000-2016)



Sources: Penn World Tables 9.0; IMF WEO; Dabla-Norris et al. (2016).
Note: The shaded area represents 10th and 90th percentiles.

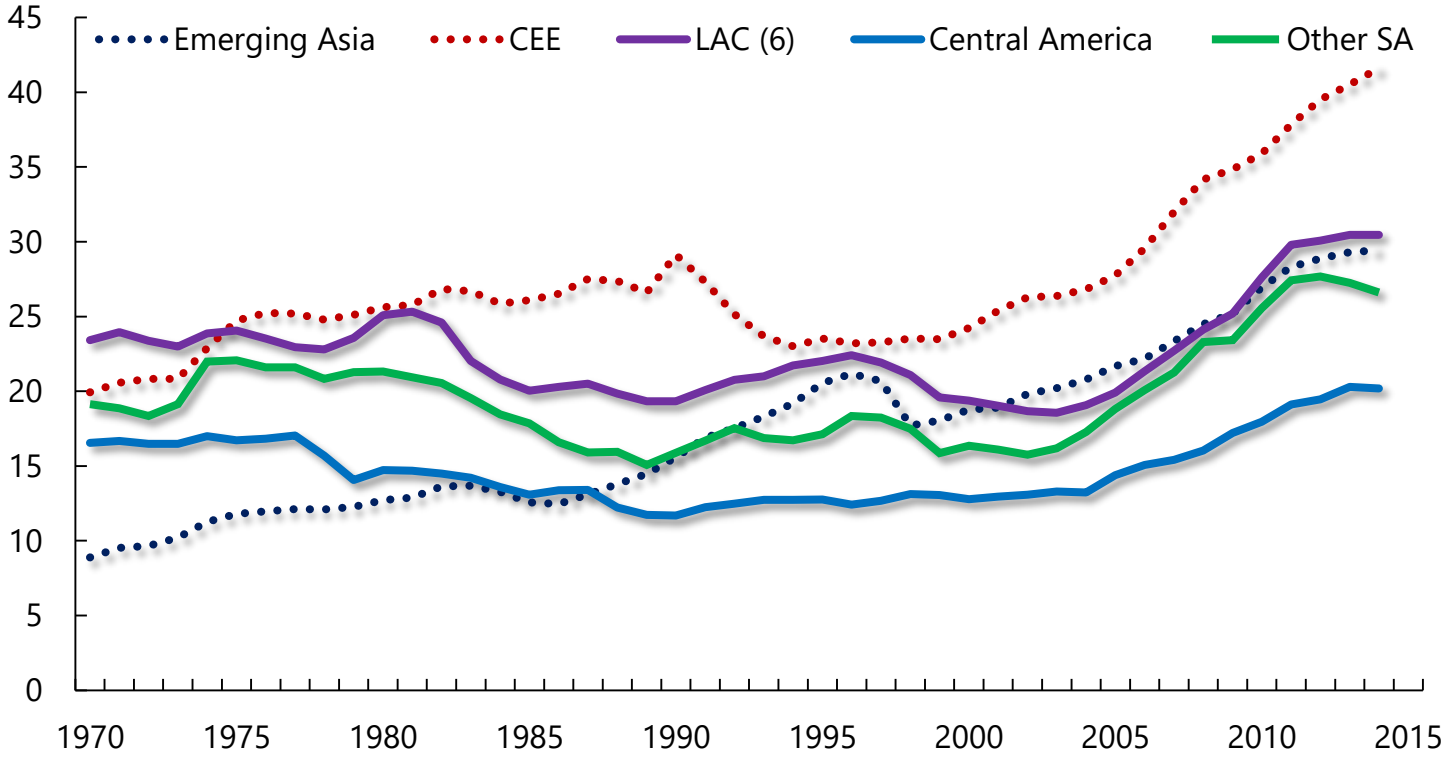
Medium-term growth prospects for the region are weak



Source: IMF WHD REO.
Note: LAC – Latin America, EME – Emerging European Economies.

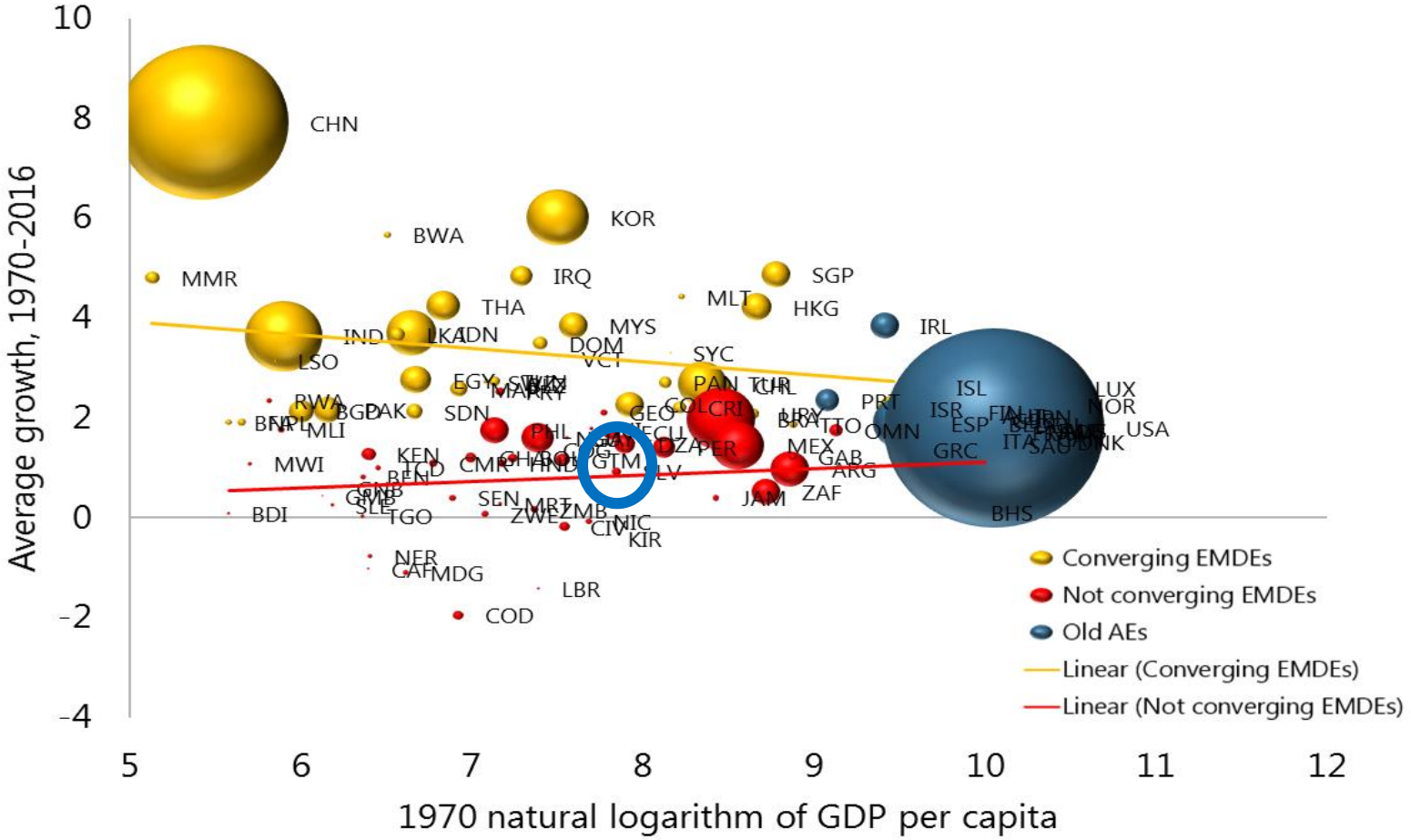
Convergence gaps in LAC remain large

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



Source: IMF (2018).
Note: Bubble size is in proportion to 2016 GDP in US dollars.

II. WHAT REFORMS ARE NEEDED?

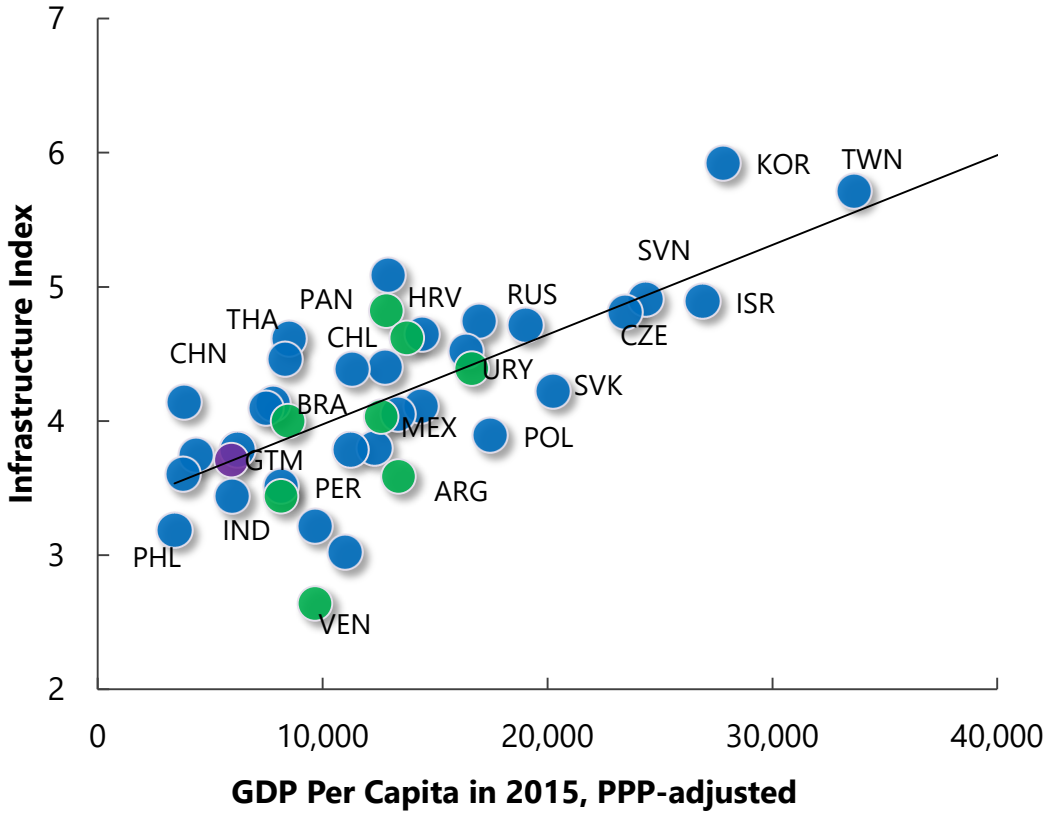
What can structural reforms do?

- **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.

I. *Polices to transform structure of production*

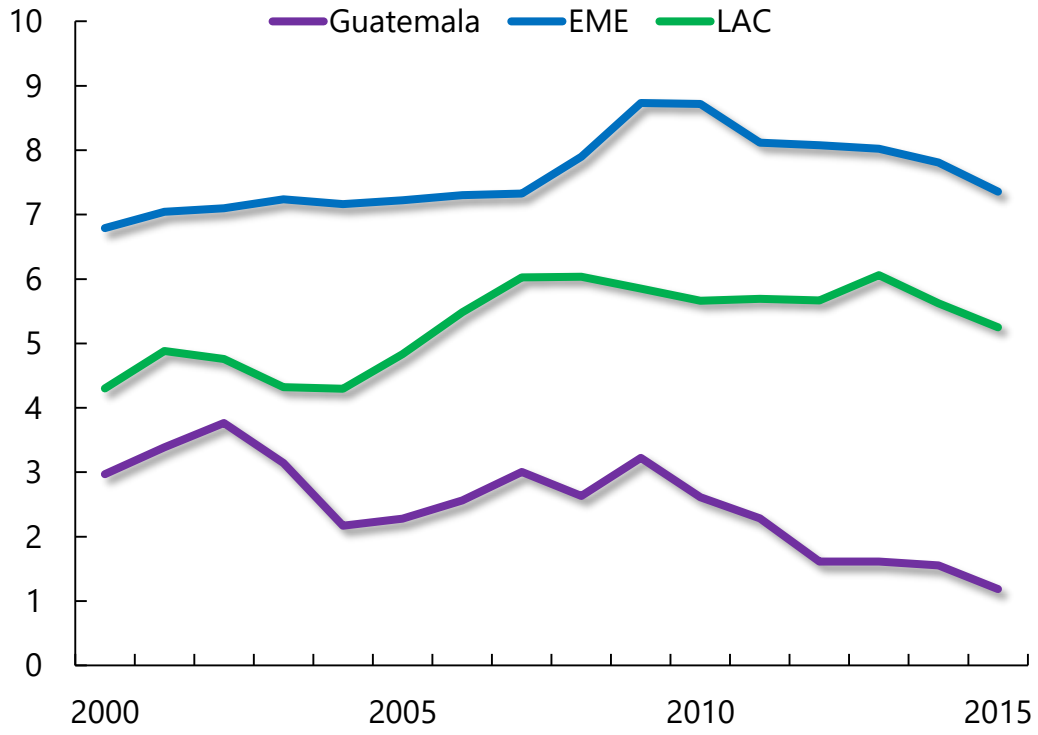
Address infrastructure gaps

Infrastructure Index
(7 represents the best infrastructure)



Source: World Economic Forum – Global Competitiveness.

Public Capital Stock
(percent of GDP)

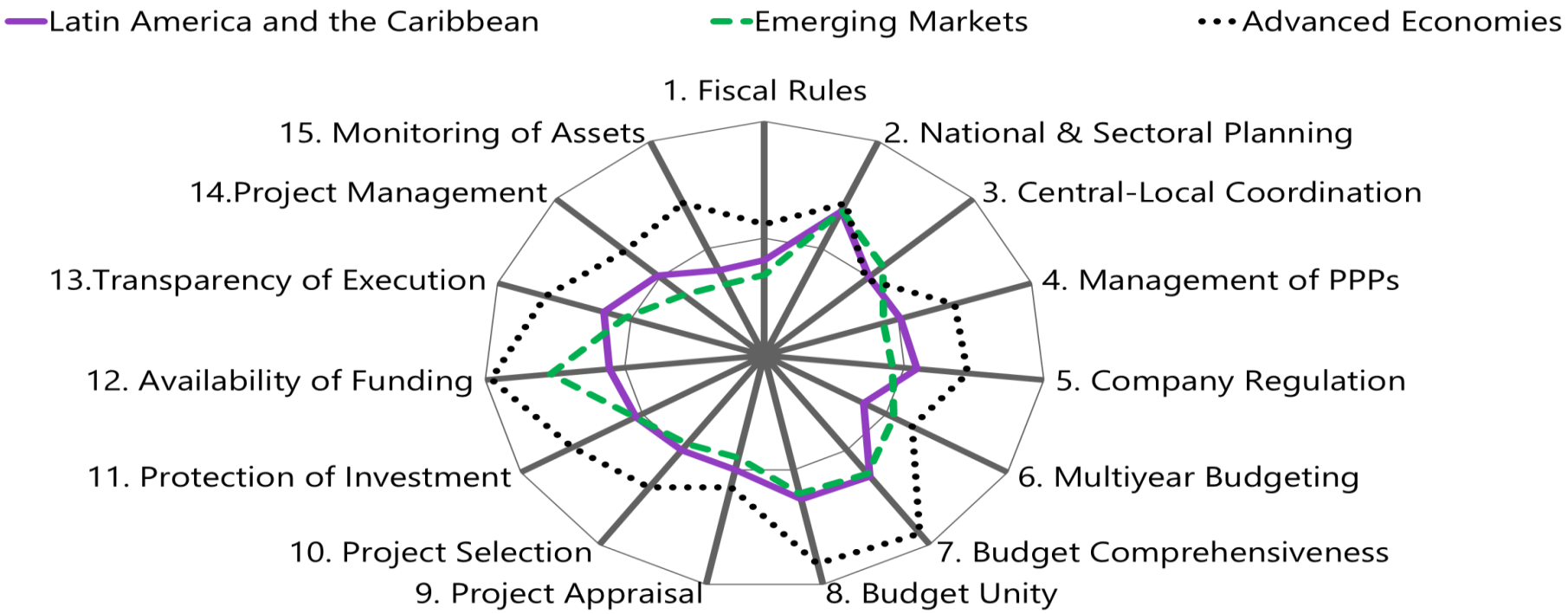


Source: IMF, Investment and Capital Stock Dataset, 2017.
Note: LAC – Latin America and the Caribbean, EME – Emerging Market Economies

Strengthen public investment management practices

Strength of Public Investment Management by Institutions

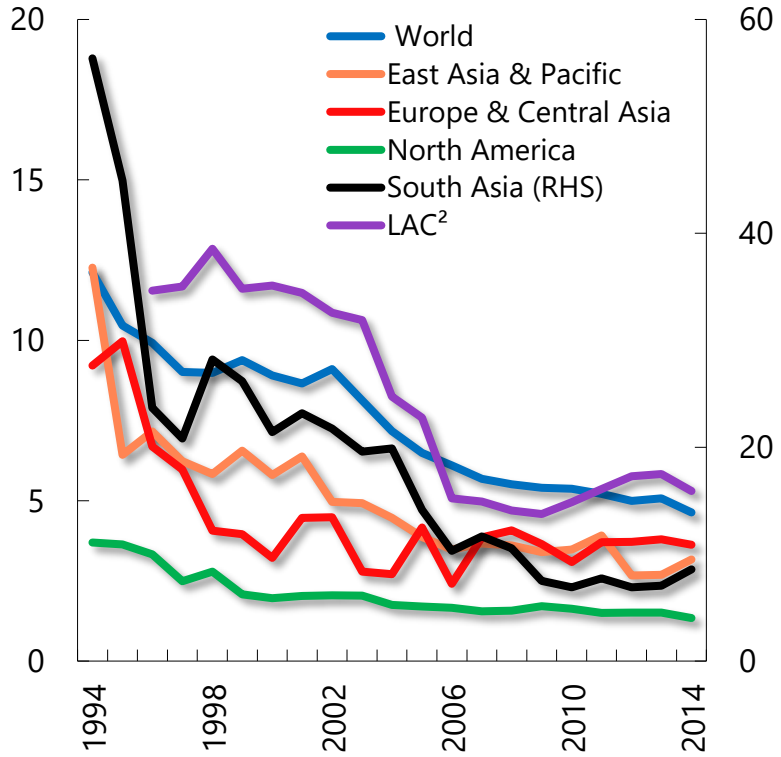
(Index: worst = 0, best = 10)



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).

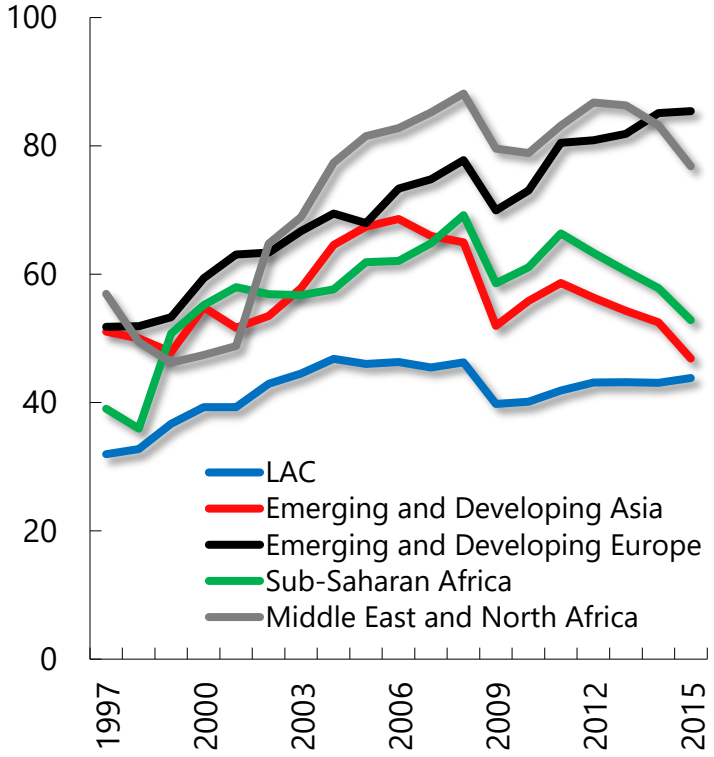
Further trade integration

Weighted Average Tariff[1]
(percent)



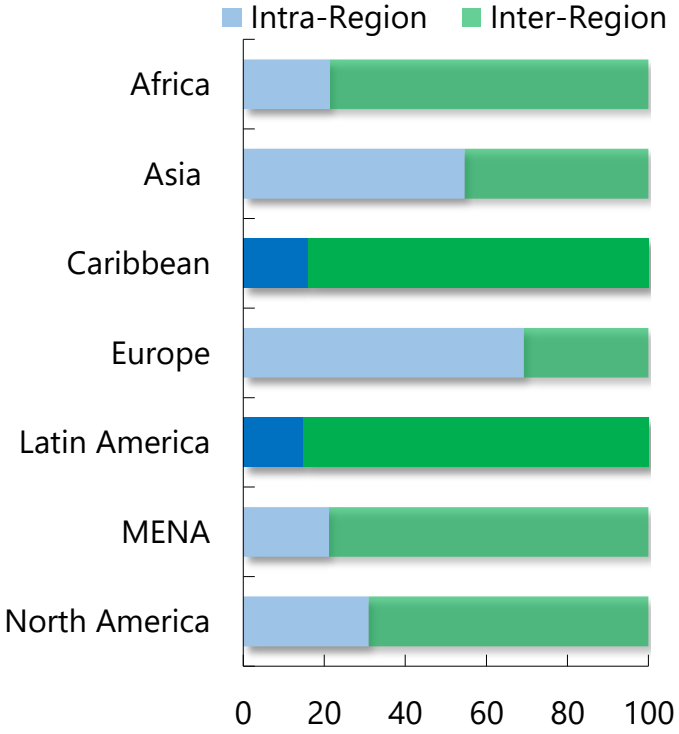
Sources: World Bank, WITS database; and IMF staff calculations.
[1]Effectively applied weighted average tariff (%): The average of tariffs weighted by their corresponding trade value figures.
[2]Refers to 3-month moving average.

Trade Openness
(percent of GDP)



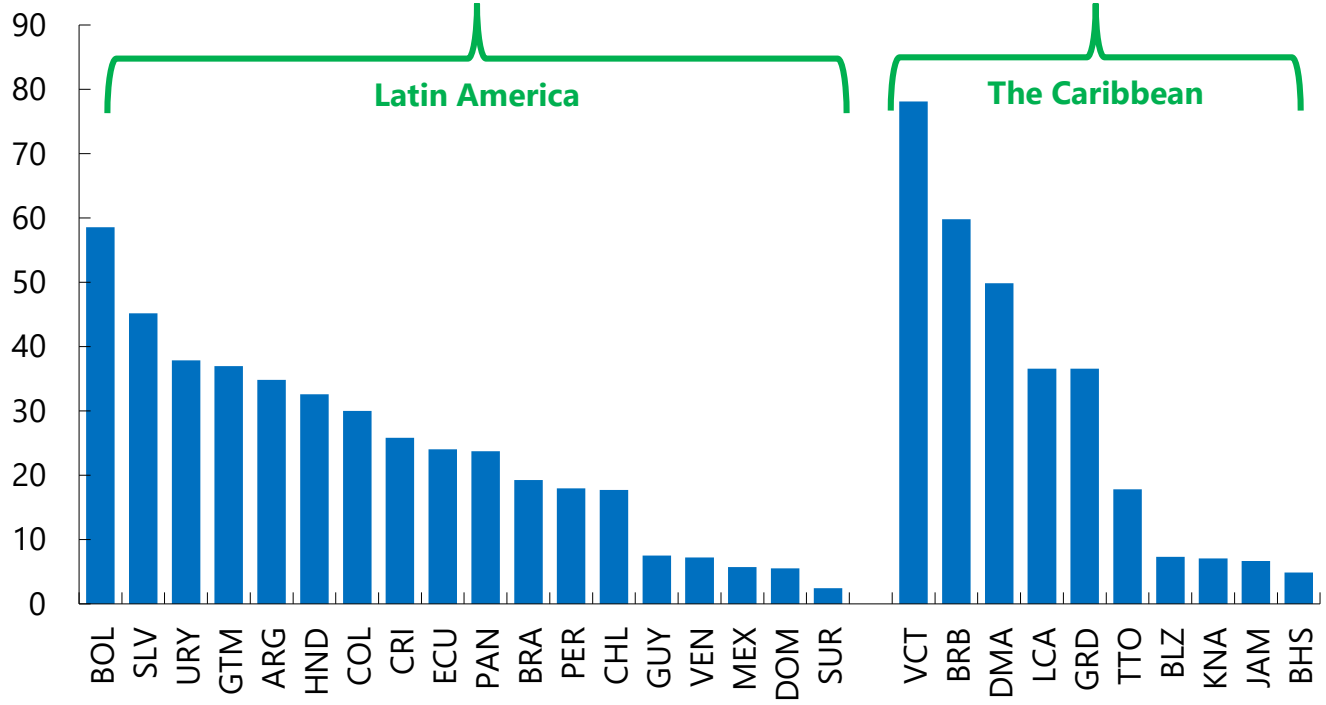
Sources: IMF, World Economic Outlook database; and IMF staff calculations.

Regional Export Shares, 2015
(percent of total exports)



Growth benefits from furthering trade integration are sizeable

LAC Exports Markets: Importance of Regional Trade[1]
(Intraregional goods exports/Total goods exports)



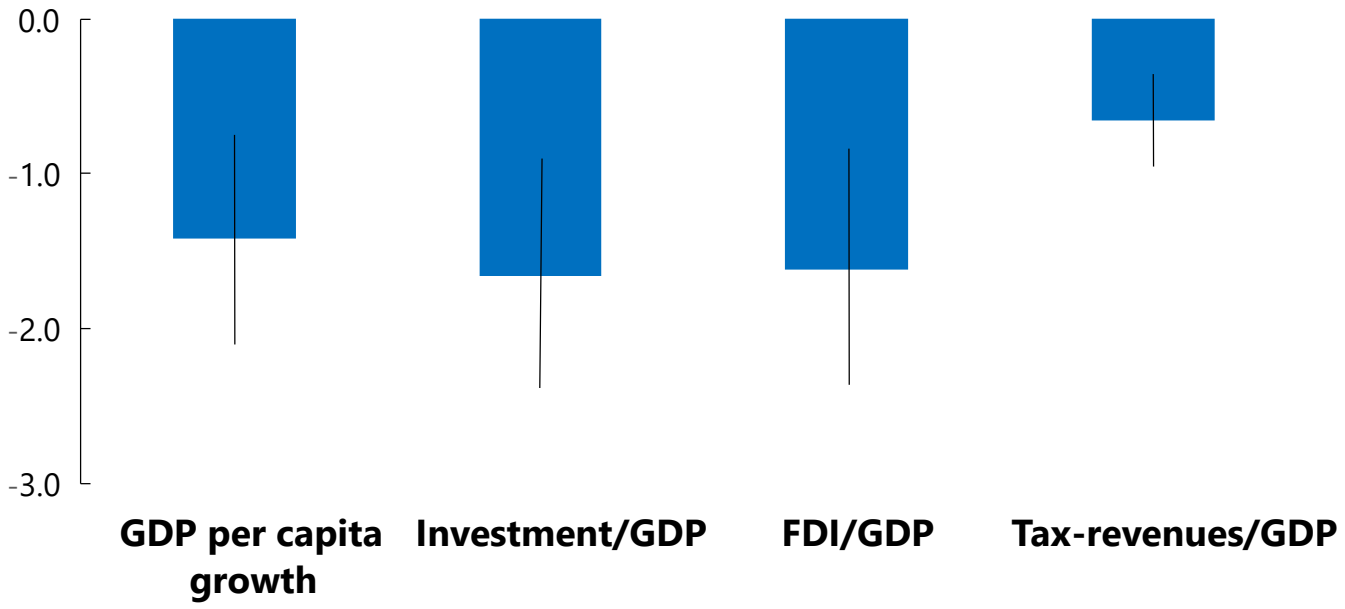
Source: IMF Direction of Trade Statistics; IMF staff calculations.
[1]Percentiles are based on the world distribution.

Estimated growth benefits:

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

Tackle corruption and strengthen governance

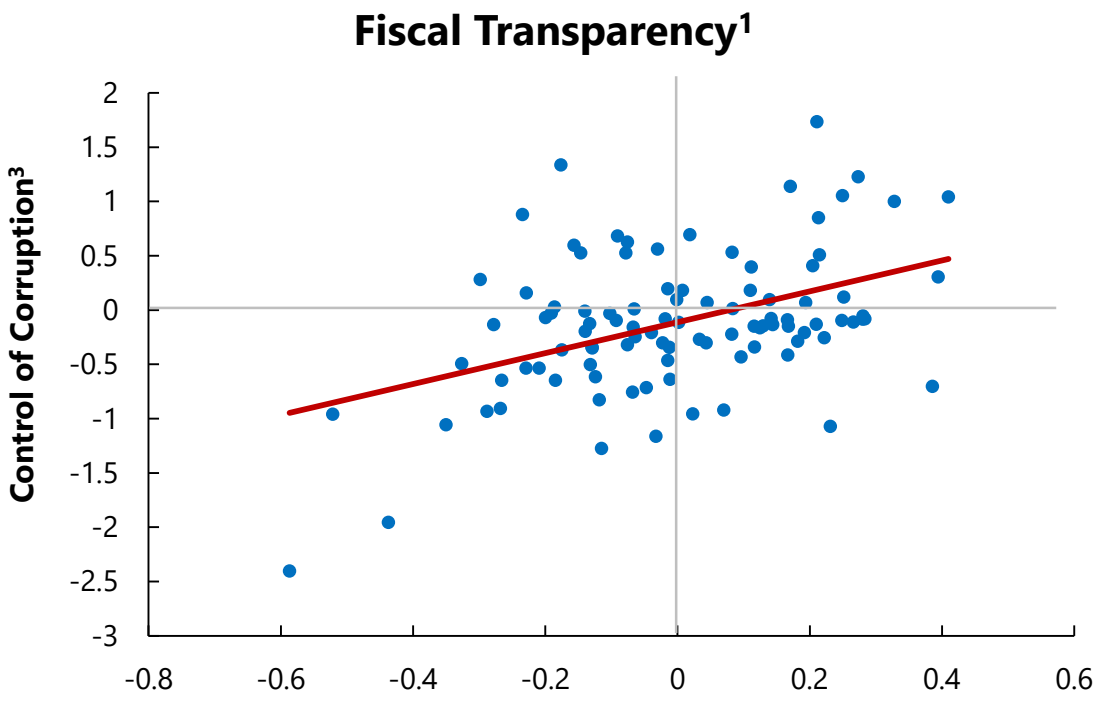
Macro-economic Effects of Corruption
(moving from the 50th to the 25th percentile of WGI CCI index)

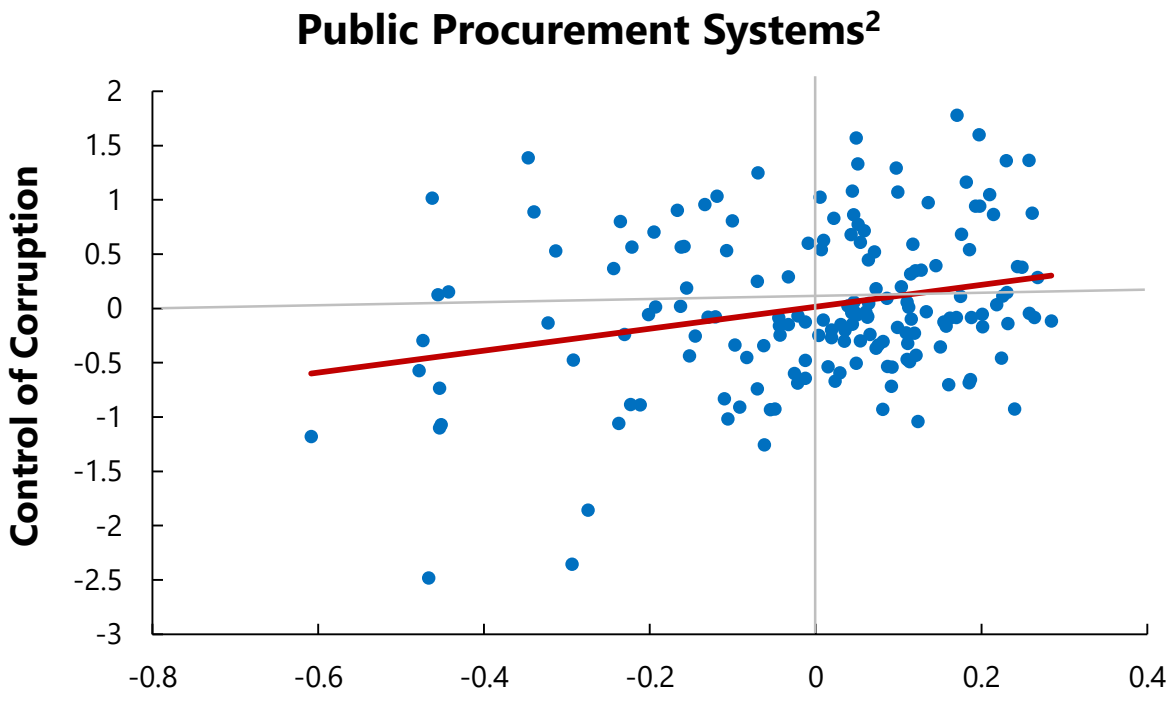


Source: IMF staff estimates based on panel regression estimates.
Note that the results are robust to different corruption indicators, solid lines indicate the 95 percent confidence interval.

- 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).

Good fiscal governance associated with perceptions of less corruption



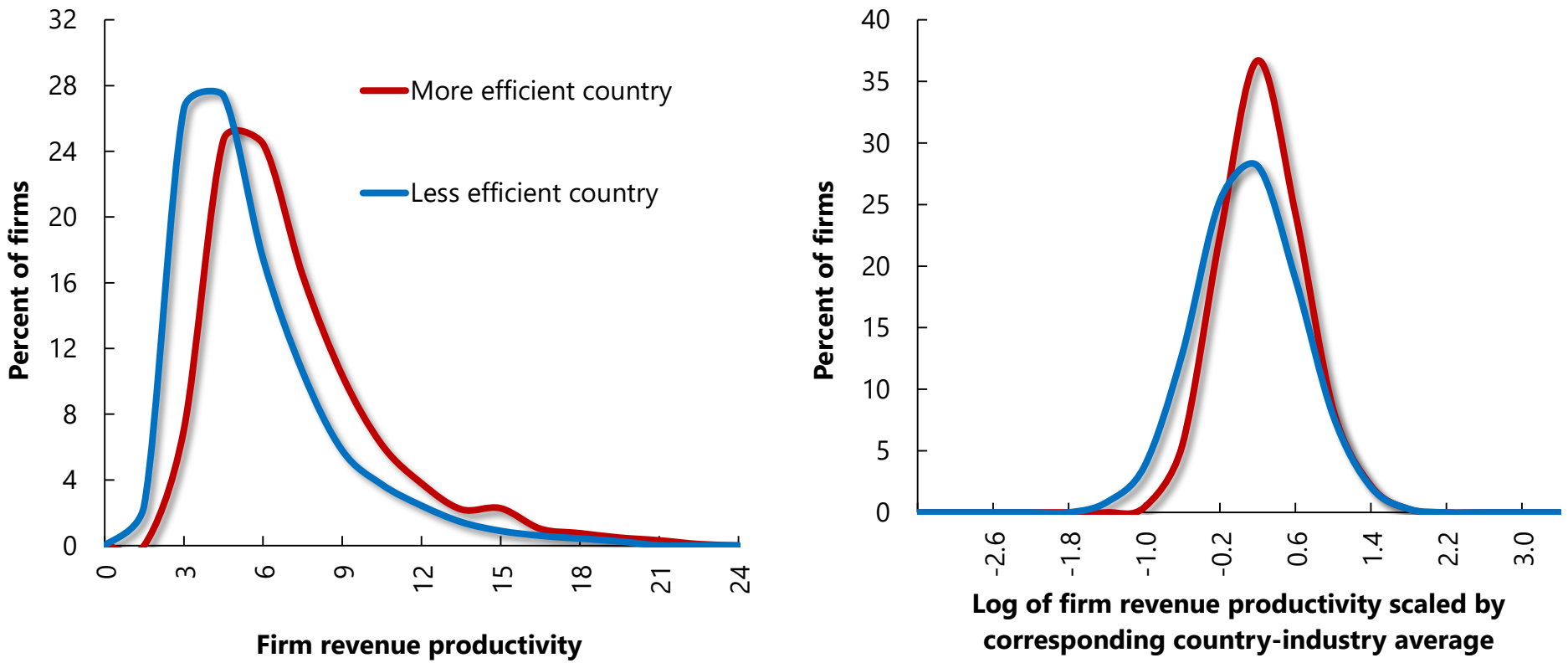


Notes & Sources: All variables shown in these charts are residuals from regressions of each variable on the level of income per capita, so that the correlations reported are not driven by economic development.
[1]Open Budget Survey: information about the auditing of public accounts and its accessibility to the public across 99 countries.
[2]Benchmarking Public Procurement (World Bank): information about the public procurement regulatory systems across 184 countries.
[3]Worldwide Governance Indicator of Control of Corruption.

II. *Polices to improve allocation of resources*

Reduce resource misallocation (dispersion of productivities across firms)

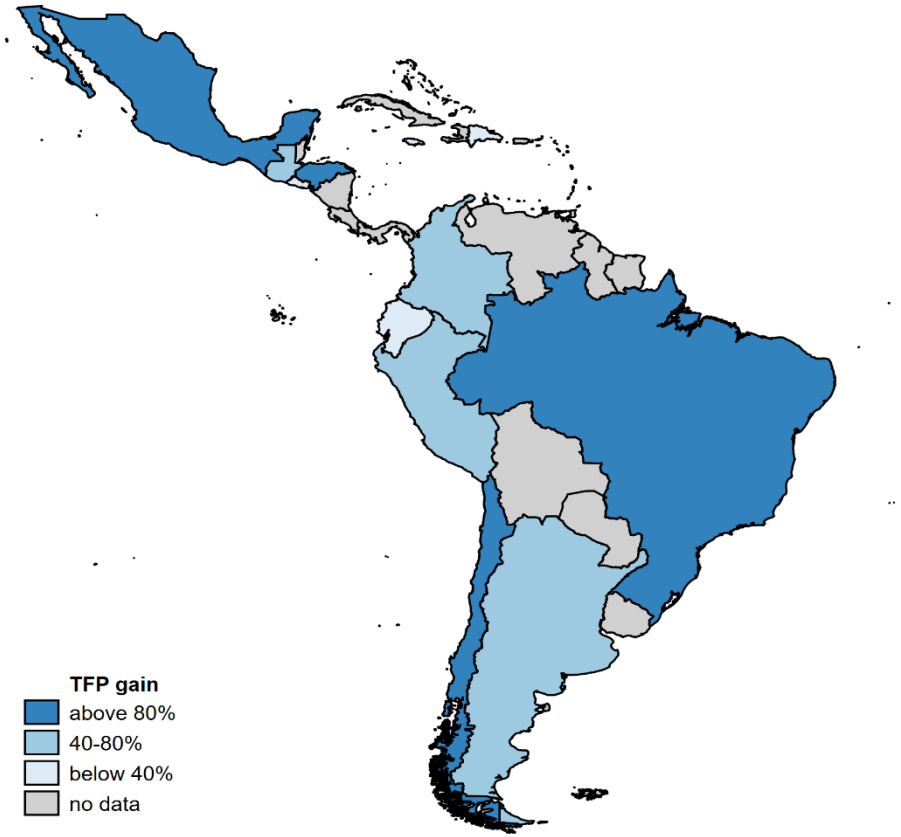
Distribution of Firm-level Revenue Productivities



Source: IMF (2017).
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.

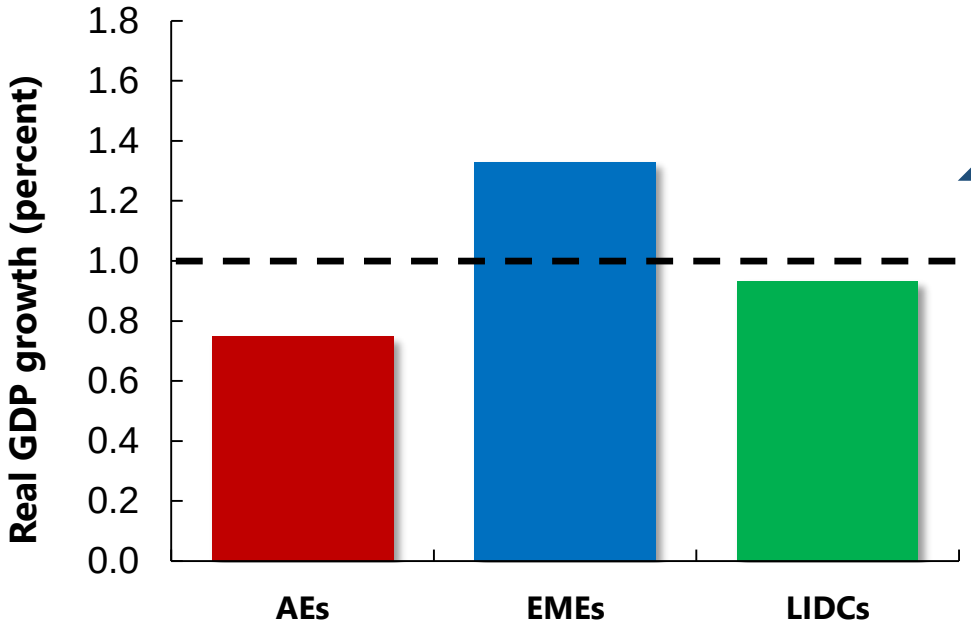
Gains from reducing resource misallocation are potentially large

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



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

Estimated annual real GDP growth effects

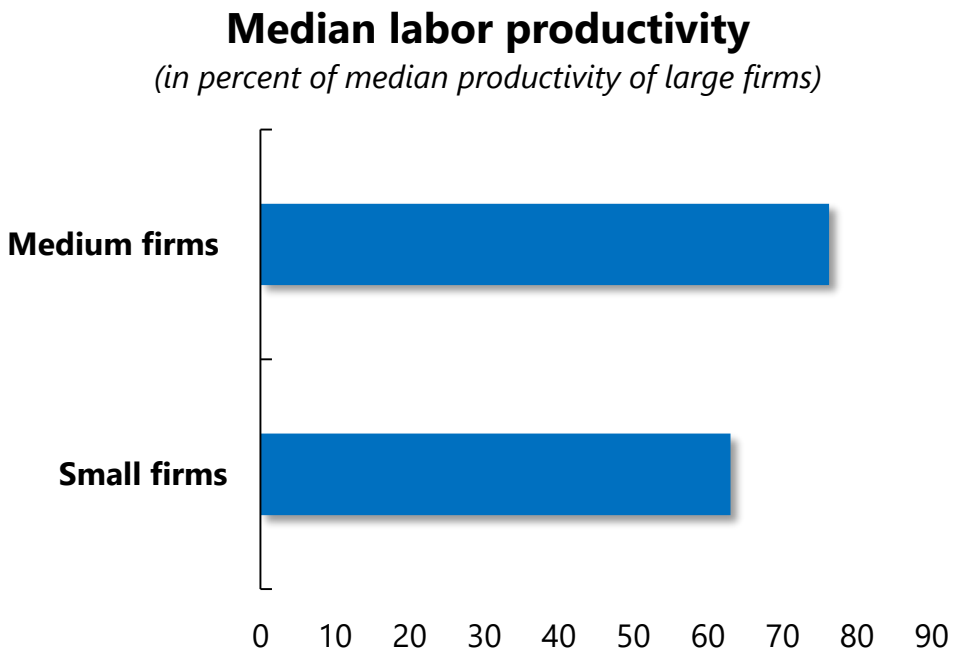


Could add 1% to real GDP growth

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

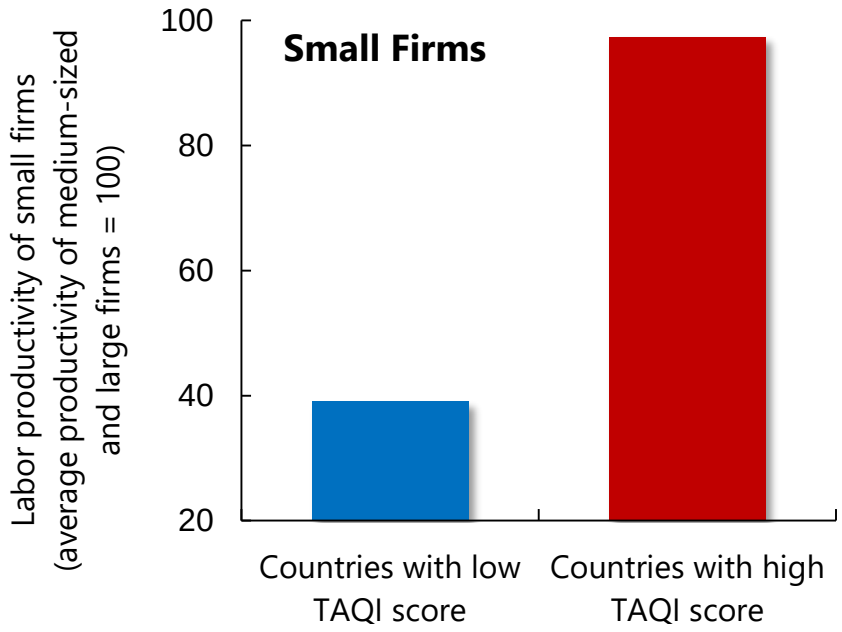
- Small and young firms are generally less productive than large and mature firms
- Share of SMEs in emerging market and developing countries is relatively high

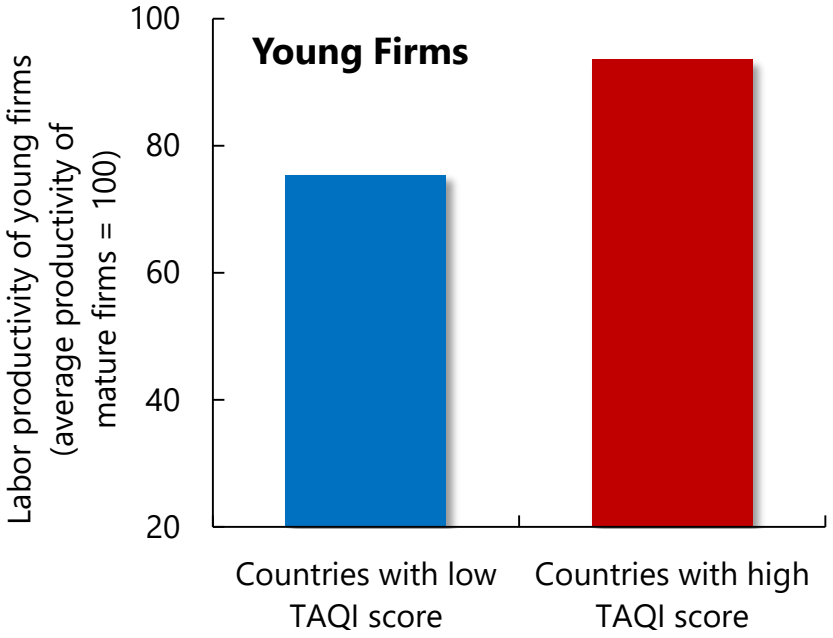


Source: World Bank Enterprise Surveys.
Note: cross-section data for 127 countries from 2009 to 2016. Medians are computed for country-industry pairs. Small firms have fewer than 20 employees, medium firms have between 20 and 100 employees.

Tax administration matters: lowering compliance costs helps small and young firms

Tax Administration Quality Index and Labor Productivity of Small and Young Firms



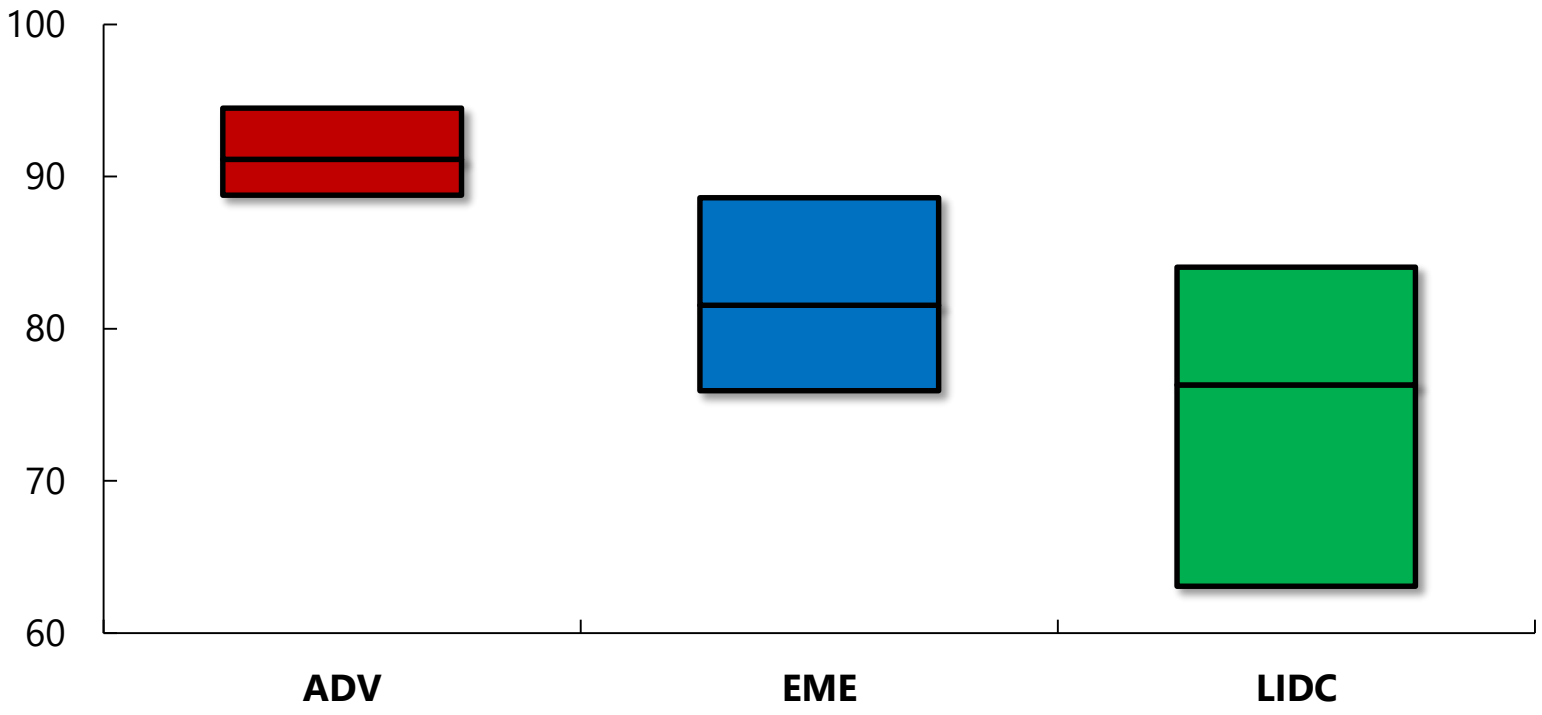


Source: Dabla-Norris and others (2017).
Note: Labor productivity refers to sales divided by the number of employees. Small firms have fewer than 20 employees; young firms are less than seven years old. A higher score on the TAQI implies lower tax compliance costs. Countries with a low (high) TAQI score 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)

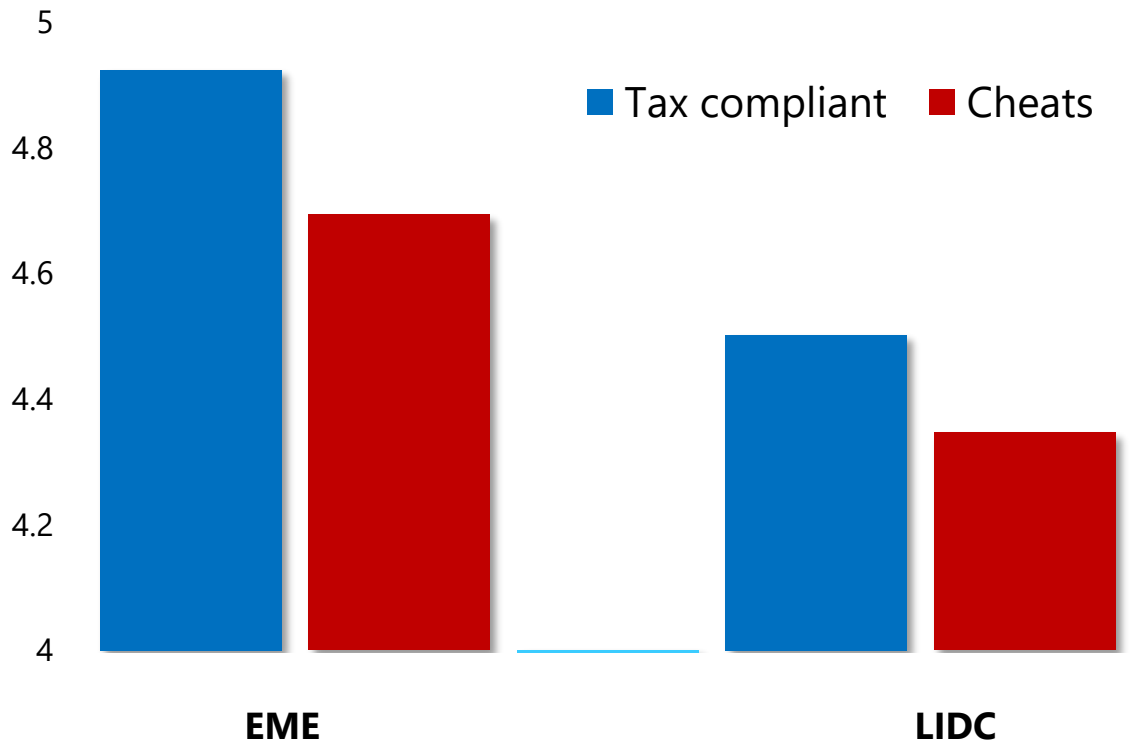


Source: World Bank Enterprise Surveys, IMF (2017)
Note: ADV = Advanced economies. EME = Emerging market economies; LIDC = Low income developing countries.

Tax evasion allows unproductive firms to prosper

- Tax evasion allows "cheats" to stay in business despite low productivity

Developing Countries: TFP across Tax Compliant Firms and Cheats

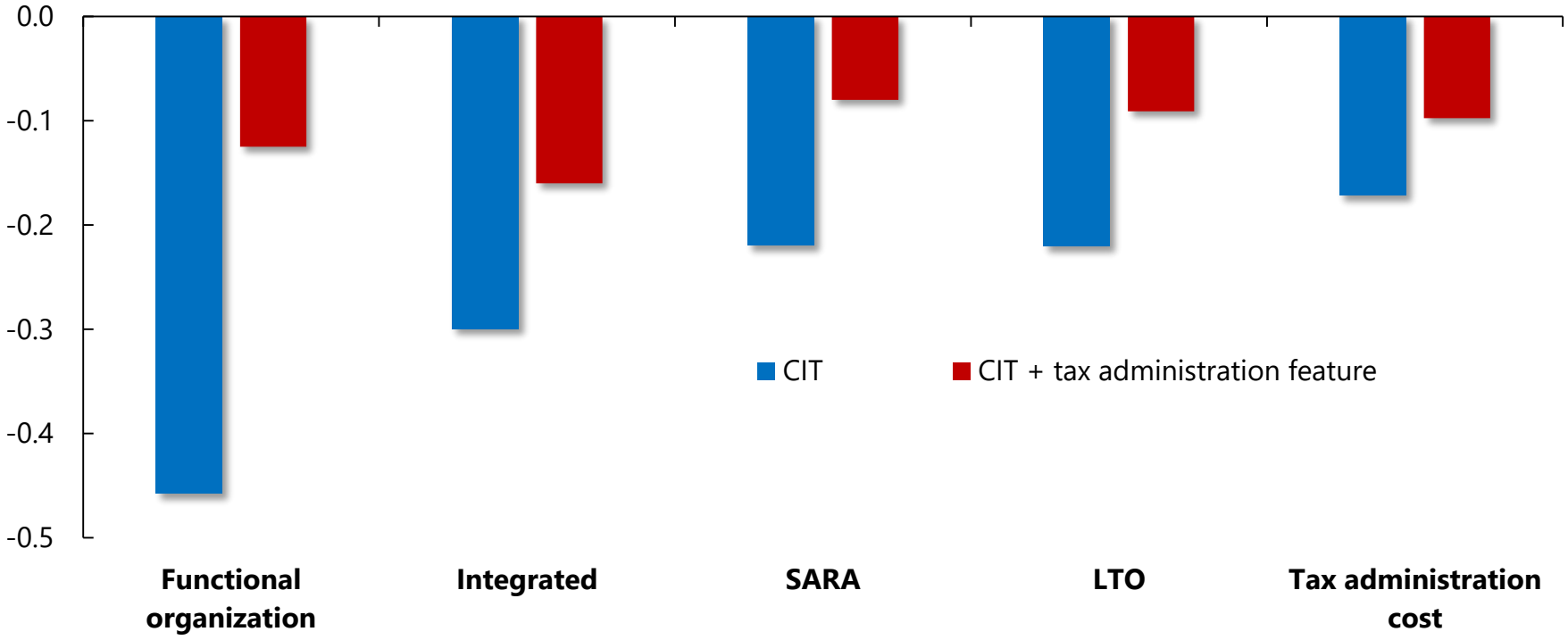


Source: IMF (2017).
Note: Cheats are defined as registered firms associated with reporting less than 100 percent of their sales for tax purposes. TFP was calculated at the firm-level, using the Levinsohn and Petrin (2004) method. EME = Emerging market economies; LIDC = Low income developing countries.

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)



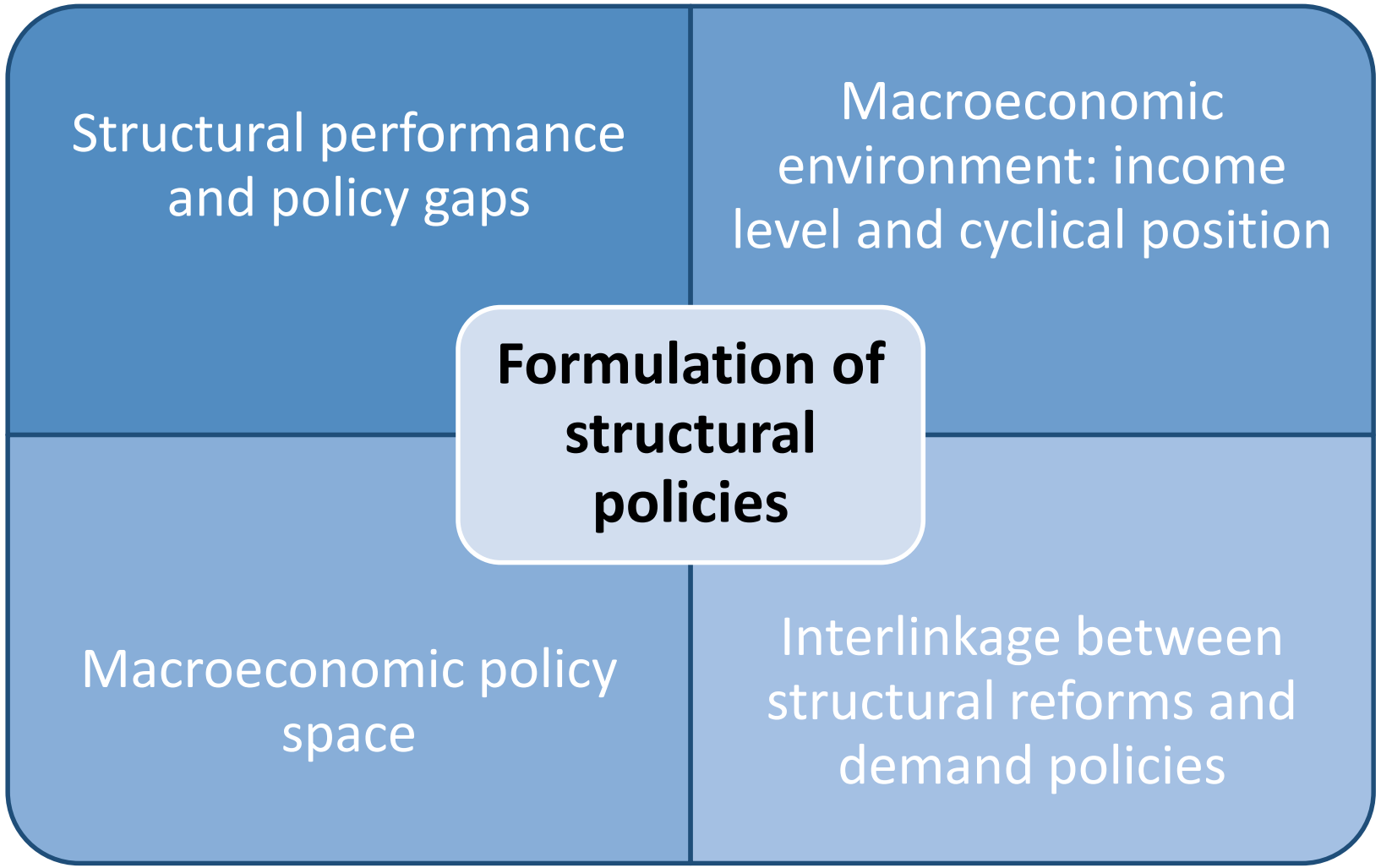
Source: IMF (2017).
Note: Effect for every percentage point of CIT.

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



Additional considerations: explore benefits and costs

Identify structural gaps and impact of specific types of reforms → Prioritize reform areas leading to faster convergence

Conditions for success →

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

THANK YOU