

EDITED BY FRANCIS FUKUYAMA

FALLING BEHIND

*Explaining the Development Gap
Between Latin America
and the United States*

OXFORD
UNIVERSITY PRESS

2008

OXFORD
UNIVERSITY PRESS

Oxford University Press, Inc., publishes works that further
Oxford University's objective of excellence
in research, scholarship, and education.

Oxford New York
Auckland Cape Town Dar es Salaam Hong Kong Karachi
Kuala Lumpur Madrid Melbourne Mexico City Nairobi
New Delhi Shanghai Taipei Toronto

With offices in
Argentina Austria Brazil Chile Czech Republic France Greece
Guatemala Hungary Italy Japan Poland Portugal Singapore
South Korea Switzerland Thailand Turkey Ukraine Vietnam

Copyright © 2008 by Francis Fukuyama

Published by Oxford University Press, Inc.
198 Madison Avenue, New York, NY 10016

www.oup.com

Oxford is a registered trademark of Oxford University Press

All rights reserved. No part of this publication may be reproduced,
stored in a retrieval system, or transmitted, in any form or by any means,
electronic, mechanical, photocopying, recording, or otherwise,
without the prior permission of Oxford University Press.

Library of Congress Cataloging-in-Publication Data
Brecha entre América Latina y Estados Unidos. English
Falling behind : explaining the development gap
between Latin America and the United States / edited by Francis Fukuyama.
p. cm.

Papers presented at an international seminar held in Buenos Aires, November 2005.

Includes bibliographical references and index.

ISBN 978-0-19-536882-6

1. Latin America—Foreign economic relations—United States—Congresses.
 2. United States—Foreign economic relations—Latin America—Congresses.
- I. Fukuyama, Francis. II. Title.
HF1480.5.Z4U535 2008
338.98—dc22 2007050154

1 3 5 7 9 8 6 4 2

Printed in the United States of America
on acid-free paper

4

Explaining Latin America's Lagging Development in the Second Half of the Twentieth Century

Growth Strategies, Inequality, and Economic Crises

JORGE I. DOMÍNGUEZ

WHAT A SHAME that the Latin American twentieth century was so short! The gap in the pace of economic growth between Latin America and the United States in terms of per capita gross domestic product (GDP) began in the seventeenth century, widened in the eighteenth century, and became extreme in the nineteenth century. In particular, the half century following independence in Latin America was, in these terms, disastrous for Mexico and bad for Central and South America. The “more-or-less twentieth century” that I evoke began with the consolidation of the Latin American states around 1870 and lasted approximately until the 1970s. From 1870 to 1950, growth of per capita GDP in Latin America was similar to or just a bit less than in the United States. From 1950 until the 1970s, the rate of growth of per capita GDP in Latin America was slightly greater than that of the

United States, but it has dropped off sharply once again since then.¹ The period between 1870 and 1970 was the only time when economic growth in Latin America was good—albeit still insufficient.

That short-lived similarity in the rate of per capita growth between the United States and Latin America implies that the relative difference between them was more or less constant over that time. According to John Coatsworth and Alan Taylor, since 1900, per capita GDP in Latin America has almost invariably been, and is to this day, just over one-fourth that of the United States.² As of 1950, the gap between the United States and the largest countries of Latin America, as one would expect from Coatsworth's observation, also experienced little change. There was generalized growth of per capita GDP of the Latin American countries from 1950 to 2000, but at a pace that was not sufficient to close the gap with the United States. As the information in table 4.1 indicates, Brazil has closed the gap to some extent, Colombia and Chile have fallen back a bit, and Mexico remains almost unchanged in terms of its gap with the United States. One notable exception is Argentina, which suffered a comparative collapse from 1950 to 2000 (see table 4.1). There are two other exceptions (not included in table 4.1) where per capita GDP declined not only in relative terms, but also in absolute terms, compared to the United States: Nicaragua and Haiti. Nicaragua's per capita GDP as compared to the United States fell from 17 percent to 6 percent during those years, while Haiti's dropped from 11 percent to 3 percent.

The difficulty facing Latin American economic growth is more striking when one takes note of the experiences of some countries from outside the region. As is also indicated in table 4.1, South Korea and Taiwan

TABLE 4.1 Per Capita Gross Domestic Product (GDP) of Some Countries as a Proportion of per Capita GDP of the United States

	1950	2000
Argentina	52	30
Brazil	17	20
Chile	40	35
Colombia	23	18
Mexico	25	26
South Korea	8	51
Taiwan	10	59

Source: Calculations used data from Angus Maddison, *The World Economy: Historical Statistics* (London: Development Centre, OECD, 2003), tables 2c, 4c, and 5c.

closed a good part of their welfare gap with the United States while they opened up a new gap with Latin America. In 1950, South Korea's per capita GDP was one-third of Mexico's, while in 2000 it was two times that of Mexico's. In 1950, Taiwan's per capita GDP was less than one-fifth of Argentina's, while in 2000 it was twice that of Argentina.

There is, nonetheless, a second gap between the United States and Latin America, and between countries of the Americas and some East Asian countries. The Latin American countries are characterized by inequalities in income distribution that are much more extreme than in the United States. Table 4.2 presents information on the magnitude of this second gap, i.e., an indicator of income inequality of several countries as a proportion of the indicator of income inequality in the United States. Table 4.2 indicates the very high inequality in the major Latin American countries and the much lesser inequality that prevails in Japan and South Korea, in both cases also as compared to the United States.

Just as the gap in economic growth between Latin America and the United States has been relatively constant over time, so too has income inequality in Latin America as compared to the United States. For example, in 1956–1957, income inequality in Mexico was 136 percent that of the United States, almost identical to what it would be more than 40 years later. In addition, the lack of variation in income distribution can also be observed by comparing each country with its own history. For example, Mexico's inequality index (Gini coefficient) was 54.0 in the mid-1950s and 54.6 in 2000.³ According to Werner Baer, the inequality index in Brazil in 1981—the last year of its economic “miracle”—was 57.9; then, as a result of the economic crisis that erupted in 1982–1983, it rose to 59.7, only slightly dropping down to 59.1 in 1998.⁴ In other words, income distribution, both within countries over time and as compared to the United States, has been relatively steady despite economic crises, changes in macroeconomic models, and the resulting adjustments in economic policy.

TABLE 4.2 Income Inequality in Some Countries as a Percentage of Income Inequality in the United States, c. 2000

Argentina	Brazil	Chile	Colombia	Japan	Mexico	South Korea
128	145	140	141	61	134	77

Notes: Measurement by the indicator of income inequality known as the Gini coefficient. United States = 100.

Source: Calculations based on data from World Bank, *World Development Indicators 2004* (Washington, DC: World Bank, 2004), table 2.7.

Both gaps with the United States originated before the period covered in this chapter, i.e., they appeared long before 1950. They arose from factors particular to the colonial period and especially in the half century after the wars of independence. Other chapters in this volume address the origins of these gaps and discuss possible explanations. The combination of both gaps, however, implies that a large part of the Latin American population has suffered and continues to suffer the dual blow of insufficient economic growth and major limitations on personal income. In short, many Latin Americans remain in poverty while the countries in which they live are not growing fast enough to generate prosperity for all of society.

This chapter analyzes two distinct and more recent moments in Latin American economic history: growth during the 1950s and 1960s, and crises since then, with reminders of the major variations among countries during this half century. It underscores the importance of the policies that several Latin American governments adopted, compared to others they could have adopted or that were adopted in other countries. All of the arguments set forth coincide on one important factor: the events that transpired could have been avoided. There is no genetic or cultural ill that impedes Latin American economic development. There are no structural factors that always and inevitably resist and impede fundamental changes in development policy.

In particular, this chapter emphasizes the following international comparative aspects:

- the general relationship between the domestic economy and the international economy
- specific policies with respect to international trade and the exchange rate
- neglect of economic inequality and poverty
- insufficient investment in human resources
- institutional instability and lack of juridical security

The general arguments made are the following:

1. The domestic economies that were able to insert themselves into the international economy have experienced swifter economic growth, both during the great international expansion of the half century preceding World War I and in recent decades, as exemplified by the countries of East Asia.
2. Those countries that adopted trade and monetary policies designed to stimulate trade with the international economy have grown more.

3. Those countries that stimulated the growth of their domestic market by reducing poverty linked to economic growth have grown more.
4. Those countries that supported and promoted the training and health of their citizens, thereby contributing to greater productivity and efficiency as well as to a better standard of living, have grown more.
5. Those countries that provided guarantees for savings and investment and kept in place reliable mechanisms for resolving litigation and political conflicts have grown more.

Latin America has performed poorly when examined under the scope of these five arguments. At critical junctures, the region has attempted to cut itself off from the international economy, often adopting policies adverse to international trade (sometimes even repressing exports). Some political leaders have confused populist rhetoric with a very limited reduction in poverty and made insufficient efforts to train their people. At key moments of the region's history, repeated military interventions have led to ruptures of the institutional order and dismantling of judicial systems.

At times, the five arguments mentioned above are presented in academic debates as contradictory, or at least as fundamentally different. This chapter recognizes that it is useful to specify whether the explanation of economic results in Latin America is due mainly to institutional factors, weak investment in human resources, or economic inequality. This is an intellectually crucial, active, and attractive debate. For the purpose of this chapter, however, it suffices to propose that these arguments actually converge. Latin America has invested insufficiently in human resources, is characterized by marked and unchanging inequality, and has suffered from an institutional framework adverse to economic growth. The accumulation and convergence of these factors explains the gap between Latin America and the United States and between Latin America and the fast-developing countries in Asia as of the end of the twentieth century.

The Worldwide and Latin American Economic Boom of the 1950s and 1960s

One important factor explaining Latin America's economic growth in the 1950s and 1960s was the benevolent context of the world economy. Japan's extraordinarily fast growth and the notable growth of the

Western European economies shaped the international economic landscape in those years. Japan's growth in per capita GDP was more than three times that of the United States, and Germany and Italy grew at double the pace of the United States. In South Korea and Taiwan, per capita growth in GDP, while less than in Japan, was faster than growth in Germany, the United States, and all of the Latin American countries. The rate of growth in the United States, however, was not insignificant: GDP per capita grew faster than at practically any other time in its history.⁵ In those years, the economies of the already-industrialized world, therefore, had the best moment in their shared economic history, with their international trade growing at almost twice the rate of growth of GDP.

In Latin America, three groups encompassing different types of economic development can be distinguished within a generalized framework of economic growth. The first includes the small Central American and some Caribbean countries. Despite difficulties during the second half of the 1950s, these countries were able to tie in to world economic growth to accelerate their own economic development and begin to diversify their productive base, especially in the 1960s. From the end of World War II until the outbreak of the world economic crisis in the early 1970s, the pace of growth of GDP in Central America was consistently greater than 5 percent annually.⁶ For these small countries with limited domestic markets, the boom in the world economy was the fundamental explanation for their economic dynamism during that period. Within this group, the champion of growth in per capita GDP was a small exporting country, the only one in the region whose rate of increased prosperity exceeded Hong Kong's and came close to that of South Korea. That country was Puerto Rico, which had free access to the U.S. market and which, in terms of income distribution and growth, outperformed both Argentina and Mexico in the 1950s.⁷

A second group of countries dominated the overall statistical results for Latin America because of the disproportionate size of their economies and, in those years, their solid economic growth patterns: Brazil and Mexico. In both countries, sustained GDP growth at more than 6 percent annually for the better part of a quarter century exceeded that of Germany and Italy during the same period, was much faster than that of the United States, and brought about major transformations in their internal economic structures.⁸ However, both Brazil and Mexico were less successful in generating prosperity than their European and East Asian counterparts, though more successful vis-à-vis the

United States, given the higher population growth rates in Brazil and Mexico.

A third group of countries—Argentina and Chile—remained below the Latin American average, with lower growth rates than those of the first two groups as well as Colombia and Peru. Nonetheless, the members of this third group did yield some growth results. The experiences of Argentina and Chile dominated much of Latin America's economic intellectual debate, thanks in large part to the renowned Argentine economist Raúl Prebisch, the key public intellectual on economic thinking for the entire region and long-time leader of the Santiago-based Economic Commission for Latin America and the Caribbean (ECLAC).

Brazil and Mexico from 1950 to the 1970s

Brazil and Mexico merit special attention for the period from 1950 to the 1970s for two reasons: their ability to grow more quickly during those decades and the fact that they account for a solid majority of Latin America's population. Brazil and Mexico stand out in many ways when compared to their Central American neighbors; however, their rate of economic growth is not a distinguishing factor. From 1950 to 1970, both the Central American economies and the economies of Brazil and Mexico grew more quickly than the U.S. economy, but they accomplished this in different ways. Central America retained a model of economic growth tied to the world economy. In contrast, Brazil and Mexico developed a model based on import substitution industrialization (ISI) and on fostering domestic production, especially in the industrial sector.

The industrialization process in Brazil and Mexico began in the late nineteenth century, when both economies were open to international trade. This process deepened and consolidated in response to the great world economic depression of the 1930s, reaching their high point in Brazil and Mexico, as well as in other South American countries, in the quarter century after World War II. Growth rates were noticeably high even when compared to the fastest-growing economies. For example, from 1950 to 1960, per capita GDP in South Korea increased by a factor of 1.44, in Brazil by 1.40, and in Mexico by 1.33. (In Argentina, by way of contrast, the increase was only by 1.11.)⁹ The differences between South Korea, on the one hand, and Brazil and Mexico, on the other, were considerable only in subsequent decades.

The annual growth of industrial production was the fundamental factor in this strategy of economic development. According to Ricardo Ffrench-Davis, Oscar Muñoz, and José Gabriel Palma, annual industrial growth in Brazil was greater than 9 percent in the 1950s and 8.5 percent from 1960 to 1973. In Mexico, it was more than 6 percent in the 1950s and 8.8 percent from 1960 to 1973.¹⁰ This notably positive experience also motivated the small Central American countries to attempt industrialization by import substitution through the formation of the Central American Common Market, a process whose success, however, was limited to the 1960s.

The import substitution strategy, it should be recalled, was not invented by Brazil or Mexico for large economies, nor did it date back only to the mid-twentieth century. At the beginning of World War I, the United States imposed a tariff on its industrial imports similar to that of Mexico, somewhat less than Brazil's, and far greater than Argentina's. In the 1950s and 1960s, as Dani Rodrik notes, there was little liberalization of imports in South Korea or Taiwan.¹¹ The Latin American innovation after 1950 was the imposition of very high barriers that hindered international trade. In Brazil, for example, as Werner Baer reminds us, the combination of tariff and nontariff barriers resulted in a level of protection in the 1950s equivalent to a tax of 250 percent on imports of manufactured goods, at the same time as exports were neglected. In the 1960s, the effective rate of protection vis-à-vis the imports of durable consumer goods was greater than 100 percent in Argentina, Chile, and Mexico, and it was 200 percent in Brazil.¹² That exaggeration of the model, in the long run, resulted in the creation of inefficient Latin American firms, poor-quality products, and worse service for consumers, who were increasingly dependent on direct and indirect government subsidies.

Neglecting exports was not an exclusively Latin American problem, though there should be no doubt that it was a problem. From 1950 to 1960, South Korea, which also followed the import substitution model at that time, increased its exports at a pace slower than that of Brazil (2.1 percent) and Mexico (3.1 percent). From 1960 to 1965, exports as a share of GDP were practically the same for Brazil, Mexico, and South Korea, which were only slightly below the figure for Taiwan. At that time, none of these were export economies.

The role of the state in setting the direction for the economy was another fundamental feature of the experience that became generalized in Latin America beginning in the 1930s. This was especially the case in Brazil and Mexico, although the state's role as the central

promoter of economic development and industrialization in “lagging” countries was not a Latin American innovation either. It had already been a major component of European industrial development in the late nineteenth century, as Alexander Gerschenkron pointed out some time ago.¹³ The Japanese experience also underscores the role of the state as a coordinator and source of capital and even as a promoter and accelerator of exports—a task carried out after World War II by Japan’s Ministry of International Trade and Industry.¹⁴ One difference that over time would take on greater importance is the fact that the role of the state in Latin America was in many cases improvised, poorly coordinated, and incompetent. In short, the ineffective action and incapacity of the Latin American state was more important than its total size in relation to the economy.

Another important element of the Brazilian and Mexican experiences was the creation of state-owned enterprises. In so doing, they merely emulated the experiences of many European countries (South Korea and Taiwan also established many state-owned enterprises in the 1950s and 1960s). By the late 1970s, according to studies sponsored by the International Monetary Fund, state-owned enterprises accounted for 25–32 percent of total domestic investment in South Korea and Taiwan, comparable to 23 percent and 29 percent in Brazil and Mexico, respectively. The contribution of these state enterprises to the deficit as a percentage of GDP was greater in South Korea and Taiwan than in Brazil and Mexico. In all four countries, it should be noted, state-owned enterprises were established in those years often in response to ad hoc situations, not as part of coherent development strategies.¹⁵ In general, state-owned enterprises running a deficit gave rise to problems in quite different countries, with the peculiarity in Latin America that these were not addressed until it was too late.

It is true that the role of the state distinguishes the economies of the United States, Brazil, and Mexico—and other countries in Latin America and Asia—but it is false that a major role for the state, in itself, impedes fast-paced economic growth. It has been a normal historical experience in several countries for the state to have a fundamental economic role, and it has been so more recently in the experiences of the countries of East Asia. From 1950 to the 1970s, the state in Brazil and Mexico—as in East Asia—facilitated the mobilization of public and private resources. The objective was, simply put, to grow, at any cost, as quickly as possible, and against every obstacle. Another difference between the role of the state in Latin America and in East Asia, beyond those already indicated, is that the first, compared to the

second, neglected both economic inequality among its citizens and investment in human resources, as we will see.

Contemporary Roots of the Latin American Lag

As already indicated, the origins of the development gap between the United States and Latin America go back much further than recent decades. Nonetheless, it is still important to analyze the shortcomings in Latin America’s economic performance in the contemporary period, once again with particular attention to the larger countries of Brazil and Mexico.

When the quarter-century boom that followed World War II came to an end, four problems loomed that were also part of the experience of the 1950s and 1960s but whose harmful results would only be apparent sometime later: lack of exports, overvaluation of the exchange rate, neglect of the economic inequality problem, and a scandalously inadequate investment in human capital. The great divergence between the economic strategies of East Asia and Latin America, as Alice Amsden argues, originated from the role of exports as a motor of development.¹⁶ Brazil and Mexico exported little and, in contrast to the countries of East Asia, did not change their strategies over time to adjust to the changes in the global economy. As of 1980, for example, exports already represented 34 percent of GDP for South Korea, 53 percent for Taiwan, and 24 percent for Thailand—a notable turnabout in their performances compared to the data cited above from the 1950s. Yet, in Brazil, this figure was only 9 percent. Comparing two oil-exporting countries that also exported other goods, both with large populations and extensive territories, exports accounted for 33 percent of GDP in Indonesia in 1980 but only 11 percent in Mexico.

In an insightful comparison of the experiences of the large Latin American and East Asian countries, Jeffrey Sachs notes that the East Asian countries persistently prevented overvaluation of their exchange rates and, therefore, did not punish their export sector.¹⁷ The Latin American countries, however, had a much more volatile experience, in some cases allowing an extraordinary overvaluation of their exchange rates, which required, from time to time, drastic devaluations of their currencies. In several Latin American countries, overvaluation of the exchange rate indirectly subsidized middle-class consumption.

These two shortcomings of economic policy in Brazil and Mexico were not impossible to rectify. In the 1950s, South Korea’s economic

profile was hostile to exports. Academics outside and inside Korea were concerned that Korean cultural values might prove to be an insurmountable obstacle that would impede economic growth. But South Korea, like Taiwan, was able to modify its economic strategy after the 1950s, just as the United States had done after World War II by establishing an international system for the liberalization of trade. While some countries carried out the necessary structural reforms for trade liberalization, Latin American countries opted not to do so.

There were, however, two other major areas in which Latin America and East Asia diverged: agrarian reform and human capital development. At the end of World War II, the United States imposed drastic agrarian reform on Japan and its former colony, South Korea; the Nationalist Party government in Taiwan also carried out major agrarian reform. In those three countries of East Asia, the rupture of the old property rights system imposed from abroad fostered equality and served as a vaccine for the future; the inequality issue was removed from the national political agenda. As table 4.2 indicates, income inequality today in South Korea and Japan is far less than in the United States and Latin America.

In comparison, Stanley Engerman and Kenneth Sokoloff indicate that, around 1900, three-fourths of the families in the United States and an even higher proportion in Canada owned their land in rural areas. At that time, the proportion of families who owned land in the Argentine pampas was less than 10 percent and in rural Mexico less than 3 percent.¹⁸ While in the United States a process of generalized acquisition of rural property was implemented, this was not the case in Latin America. In most Latin American countries, agrarian reform did not take place, and where it did, the process was partially delinked from a market economy framework (in contrast to the countries of East Asia). The Mexican agrarian reform, for example, hindered the full participation of the *ejido* system in the market economy, condemning the *ejidatarios* to poverty. In Brazil and Mexico, as in other Latin American countries, the demand for land redistribution in violation of property rights persisted.

Neglect in addressing economic inequality has another component: racial or ethnic discrimination. Countries as different as Cuba, the United States, India, and South Africa have shown that official policy can change inequality among racial or ethnic groups, but of course, it is necessary to develop an effective policy. In general, Latin American governments, until very recently, paid little attention to this issue and, in many cases, even denied the existence of a problem. Research at the World Bank, however, indicates that—controlling statistically for

individual factors such as education, occupation, and income—racial or ethnic discrimination may explain one-fourth of the differences in income between indigenous and nonindigenous persons in Bolivia; half in Guatemala, Mexico, and Peru; and half in Brazil between whites and nonwhites.

Finally, Latin American countries in general, not just Brazil and Mexico, have invested much less in the development of human resources than have the countries of East Asia. In Latin America, compared to other countries, enrollment rates of students in primary and secondary schools have remained low, and the quality of the educational system has generally been inferior. Table 4.3 summarizes the information on secondary school enrollment. The enrollments in Mexico are approximately half of those recorded in South Korea, Spain, and the United States. Brazil's results are especially poor: enrollment of the appropriate age group in secondary education is one-fourth what one finds in Korea, Spain, and the United States.

In addition, as indicated in table 4.3, teachers with 15 years of experience in primary schools in Brazil receive salaries that are less than half

TABLE 4.3 Enrollment in Secondary Education and Public Primary School Teacher Salaries, 1995–1998

	% Net Enrollment in Secondary Education, 1995	Public Primary School Teacher Salary (\$), 1998
South Korea	96	39,921
Spain	94	29,590
United States	89	33,973
OECD	nd	28,441
Thailand	nd	15,759
Argentina	59	9,442
Chile	55	15,233
Malaysia	nd	10,876
Colombia	50	nd
Mexico	46	12,450
Brazil	19	6,451

Notes: nd = no data available

The salary is for a teacher with 15 years experience, in U.S. dollars, expressed as per the purchasing power parity (better known by its acronym in English, PPP).

The enrollment figure shows enrollment as a percentage of the secondary school-age population.

OECD = Organisation for Economic Co-operation and Development.

Source: Partnership for Educational Revitalization in the Americas, *Lagging Behind: A Report Card on Education in Latin America, 2001* (Washington, DC: Inter-American Dialogue, 2001), pp. 29, 42, based on UNESCO and OECD data.

of what their peers in Thailand are paid. The salaries of primary school teachers in Mexico do not even reach half the average of the member countries of the Organisation for Economic Co-operation and Development (OECD), of which Mexico is a member. It should not surprise us, therefore, that the quality of education imparted is deficient. Take Chile as an example. It leads Latin America in terms of pay for school-teachers and ranks second in secondary school enrollment. Yet Chile performs poorly in the quality of its education according to international comparisons. Table 4.4 presents calculations derived from an international test done in 1999 in dozens of countries on eighth-grade students' knowledge of mathematics. The results in the United States are just above the world average. South Korea's results are better than those of the United States in both tables 4.3 and 4.4. Chile, the best performer in education in Latin America, is far behind in relation to the rest of the world: its performance is surpassed by Thailand in both tables 4.3 and 4.4 and in academic performance even by Malaysia, where teachers' salaries are below those of Chile. If Chile's quality of investment for human development lags behind internationally, it follows that the overall weakness of Latin America's competitiveness should not be surprising.

The low investment in and poor quality of human resources in Latin America hinder the development of alternative mechanisms of social mobility, greater prosperity, and the total elimination of poverty. The region's growth from the end of World War II until the 1970s owed more to population increase, which fed the labor market, and the injection of capital (largely foreign), and not to productivity gains. It is not surprising that annual growth of productivity in Latin America, according to World Bank and Inter-American Development Bank studies, has been less than the annual increase in productivity in the countries of East Asia in the three decades since 1970 and, in the two decades beginning in 1980, even less than the annual productivity gains in the countries of South Asia.

TABLE 4.4 Academic Performance in Mathematics of Eighth-Grade Students as a Percentage of Performance in the United States, 1999

South Korea	Malaysia	United States	International Average	Thailand	Chile
117	103	100	97	93	78

Source: Calculations based on data from Partnership for Educational Revitalization in the Americas, *Lagging Behind: A Report Card on Education in Latin America, 2001* (Washington, DC: Inter-American Dialogue, 2001), p. 32.

Poverty impedes full participation in the economy and society. As the twentieth century drew to a close, the proportion of the population with incomes lower than \$2 per day was 22 percent in Brazil and 26 percent in Mexico, but less than 2 percent in South Korea and 9 percent in Malaysia, according to World Bank figures.¹⁹

The Basket of Institutions

One purpose for developing political economy institutions is to reduce uncertainty so as to facilitate investment, innovation, and efficiency. For Douglass North, among others, democratic political regimes and decentralized market economies, with clear and well-protected guarantees for property rights, are the preferred institutions for generating an institutional framework with an effective capacity to adapt.²⁰

The most developed economies in the world are in countries with democratic regimes. Yet economic growth has occurred in both dictatorships and democracies. In the years covered by this chapter, for example, there was impressive economic growth in the European democracies and Japan as well as in China, South Korea, and Taiwan, the last two ruled by dictatorships until the early 1990s. In addition, there was economic growth a hundred years ago in both the United States and czarist Russia.

The Latin American countries that grew the most from 1950 to the early 1970s were Brazil, Costa Rica, and Mexico. During those years, there was a high rate of growth in per capita GDP in both democratic Costa Rica and Nicaragua under the Somoza family dictatorship—greater in Costa Rica in the 1950s and greater in Nicaragua in the 1960s.²¹ Mexico maintained an authoritarian political regime, and Brazil had a democratic regime (with major shortcomings) until 1964 and an authoritarian one from 1964 on. From the world crisis of 1973 to the end of the twentieth century, the best growth in per capita GDP occurred in Colombia (democratic) and Paraguay (authoritarian until the end of the 1980s).²²

It is useful to think in terms of a basket of rules, or institutions, which in different combinations generate economic growth, despite other differences between countries and political regimes. This concept of a basket of institutions also helps to account for what appear to be anomalous cases. For example, one institution particularly favored by Douglass North and many others is the guarantee of property rights, which is fundamental for reducing uncertainty as it guarantees

the future for many economic actors. However, when the United States gained its independence in 1783, there was a dramatic redistribution of property—uncompensated expropriations—through emigration, in many cases forced, to British North America (today, Canada) of many of those who were loyal to the colonial regime. There was a second major violation of property rights in the United States in the wake of the Civil War in the 1860s. The agrarian reforms in South Korea, Japan, and Taiwan shortly after World War II have been previously mentioned. In the case of South Korea, the dictatorship that began in 1961 instituted, among its initial measures, the imprisonment of large entrepreneurs in addition to confiscating their property. It is clear, then, that economic growth is achievable in countries where property rights have been violated. One possible response is that property rights may be violated just once, but the examples above show two violations in the United States and two in South Korea during the same decade. In these various examples, property rights violations occurred in connection with war or similar major events. In Western Europe, North America, and East Asia, property rights have ordinarily been protected in peacetime, and this is a key difference with Latin America.

A distinctive feature in Latin America has been the systematic and enduring persistence of violations of property rights, even in the absence of international wars or prolonged civil wars. That persistence, in several cases still a pressing issue to this day, brings about conditions of permanent insecurity for savings and investment and stimulates capital flight in search of the rule of law. Accordingly, most of the Latin American countries lack institutions capable of creating trust in the existence of a rule of law that protects long-term investments, which in turn would bring about sustained economic growth.

Democracy is also an institution that guarantees future stability, since it regulates the rotation of the president or prime minister depending on the constitutional arrangements. The replacement of one head of government by another, even if by a politician from an opposition party, is a normal procedure under established and known rules in a democratic regime. That rotation does not pose a danger to stability; to the contrary, it consolidates it.

This analysis suggests a way of distinguishing dictatorships capable of making commitments that affect the future from those that do not have that capability. For example, the old absolute monarchies had a mechanism to guarantee commitments into the future: dynastic succession. Some of the dictatorships with better economic results have also been dynastic, as in the case of Taiwan. Nicaragua's economic

growth accelerated after the assassination of Anastasio Somoza García because there was a successful transition from unipersonal to dynastic power, in sequence, to his two sons. Dynastic succession, of course, does not replace the need to adopt effective economic measures, and such a system is vulnerable depending on the quality of the heirs. Spain's economic experience in the seventeenth century, Haiti's under the Duvalier family from the 1950s to the 1980s, and North Korea's since the 1980s are examples of dynastic systems that have encountered such problems. Dynastic succession is, thus, not a reliable solution nor is it to be recommended.

More effective have been the institutions of authoritarian regimes that adopted orderly mechanisms of succession, in many cases written into the constitution. Mario Vargas Llosa characterized the old Mexican political system as a "perfect dictatorship" for various reasons, but one was its capacity to assure a peaceful transfer of power from one president to another, on schedule, every six years.²³ The military regime that came to power in Brazil in 1964 also adopted, over time, Mexican-style procedures for succession. Both Brazil and Mexico, as already noted, had excellent results in terms of economic growth from the end of World War II until the early 1970s.

Communist China did not yield significant economic growth results during its period of authoritarian rule by one person, whose caprices brought about spectacular human and economic disasters. China's subsequent economic growth occurred for several reasons, but one of them is a major change in its political system: it ceased to be a one-person dictatorship. Relatively stable mechanisms for political succession were put in place, allowing the government to make commitments into the future and in the name of the party and state institutions.

The institutions of the political regime alone do not generate economic growth. Adequate economic policies are required to achieve growth, but the political institutional frameworks offer reasonable guarantees that the policies established will endure, thereby encouraging economic actors—in both democracies and in authoritarian regimes with mechanisms of succession under a constitutional regime—to commit to invest more and to innovate in a more predictably stable future.

The relationship between the rotation of the head of state or government and the ability to guarantee property rights is crucial. In a political regime without institutionalized procedures for presidential rotation, a president and his or her minister of finance can only make a commitment to the fundamental rules that guarantee property rights

and frame the conduct of the economy up to the time of their deaths or removal from office. A political regime with institutionalized procedures for the rotation of the head of state, whether authoritarian or democratic, has the means to guarantee fundamental economic rights in the long term. Compliance with those economic rules does not depend on a single person but on the constitution of the regime.

In Latin America, therefore, the excellent economic performance from 1950 to 1973 of Brazil, Costa Rica, and Mexico has one main factor in common: the three very different political regimes had institutions that governed the peaceful and constitutional transfer of the presidency (the main exception being the military coup in Brazil in 1964). The solid economic growth of the Central American countries in the 1950s and 1960s mentioned above was also accompanied by relatively stable mechanisms for the rotation of the presidency through selections internal to the armed forces. Among the larger economies of Latin America, the one that avoided a major economic setback from 1981 to 1983 was Colombia, which had effective constitutional mechanisms for managing its macroeconomic policy despite suffering terrible problems of public violence.

The worst result, as table 4.1 indicates, was in Argentina, the only Latin American country with triumphant military coups in the 1950s, 1960s, and 1970s and repeated military uprisings or attempted coups during the 1980s and up to 1990. The Argentine military regimes, moreover, suffered from another shortcoming: they generated their own instability, since the country suffered military coups under each of the military regimes established in 1962, 1966, and 1976.²⁴

Argentina's exception in terms of its poor economic performance has another institutional characteristic that has been identified in Gretchen Helmke's research: the creation of juridical insecurity through the systematic destruction of the capacity for autonomous action in the Supreme Court.²⁵ One crucial function of the Supreme Court is to provide a collective and institutional guarantee of the established rules, including the guarantee of property rights, which is necessary for economic growth. That guarantee of the rule of law must necessarily be independent of the political affiliations of the members of the Supreme Court. It should be a guarantee of the state, not of the individuals who perform public functions.

One moment of transition on the road to juridical insecurity in Argentina was the removal of three of the five members of the Supreme Court and the forced resignation of the fourth one in 1947. That decision had enduring repercussions. As of the military coup in 1955, most

of the members of the Supreme Court were replaced with each change in political regime until 1983. Under the military government, they were removed by decree; under democratic governments, by forced resignation. The result was a notable politicization of the Supreme Court, which, in different ways, persists to this day because something similar happened in the transition from the presidency of Raúl Alfonsín to the presidencies of Carlos Menem and Néstor Kirchner. The Supreme Court in the Argentine republic can only guarantee those rights of interest to the incumbent president, whoever he or she may be. That guarantee is only useful so long as that president is president; in other words, it is not truly a guarantee of the state. It is thus understandable that crises have interrupted the moments of economic growth.

A Bad Start to the Twenty-First Century in Latin America

The world economic crisis of the early 1970s—which combined a devaluation of the dollar, an abrupt increase in oil prices, an increase in inflation in both the developed countries and the less developed ones, and a world economic recession that characterized a good part of that decade—left Latin America poorly positioned to start the twenty-first century. The old patterns of stability in the international economy suddenly broke down, requiring countries to become more agile in their capacity to maneuver. It is not difficult to understand why Latin America faced economic difficulties after the 1970s, as did the rest of the world. However, by the 1980s, North America, Western Europe, and in particular East Asia were emerging from those difficulties; Latin America was not.

The key question is: what happened in Latin America during the 1970s when North America, Western Europe, and East Asia were reorganizing their economies? In several Central American countries—Guatemala, El Salvador, and Nicaragua—cruel internal and international wars broke out, indirectly affecting Honduras and Costa Rica. The constitutional governments were overthrown in Argentina, Ecuador, Chile, and Uruguay, the latter two having stood out for decades for their institutional stability. The military governments of the Southern Cone, in the name of protecting “Western civilization,” assassinated thousands of their fellow citizens without the least respect for legality and human rights. In addition, the institutional instability of authoritarian military regimes, already noted in the extreme case

of Argentina, was also observed in the military regimes of Bolivia and Peru, i.e., military coups were launched even against military governments. In such cases, the “forces of order” were the worst generators of disorder. By the mid-1970s, authoritarian regimes, almost all of them military, prevailed in Latin America except for Costa Rica, Colombia, and Venezuela.

It was these authoritarian governments that made the decision to go into debt rather than adjusting Latin America’s economic structures to address the world economic crisis. They were the ones that retained, and around the late 1970s exaggerated, the overvaluation of the exchange rate. They were the ones (except for Chile) that ignored the need to fundamentally modify the anti-export orientation of a large part of the national economy. One may also recall that they invested little in human resources and neglected the issues of inequality and poverty. By postponing the adjustment, as in any case of deferred maintenance, they necessarily increased the later cost of that adjustment, which came the next decade.

The fatal governmental decision to fall into debt instead of adjusting—to borrow money for the state’s consumption rather than using those resources to stimulate production and promote exports—was particularly evident on the eve of the Latin American economic catastrophe known as the debt crisis, as summarized in table 4.5. Abruptly increasing interest payments to service the debt in a context of insufficient exports was irresponsible, and it was impossible to use the vast new financial resources efficiently and productively in such a brief period. While the most worrisome financial behavior was on the part of the Argentine military government, the conduct of the government of General Augusto Pinochet in Chile does not merit any praise either.

TABLE 4.5 Ratio of Total Interest Paid to Exports of Goods and Services (%)

	1978	1982
Argentina	9.6	54.6
Brazil	24.5	57.1
Chile	17.0	49.5
Mexico	24.0	39.9

Source: United Nations Economic Commission for Latin America and the Caribbean, *Balance preliminar de la economía latinoamericana durante 1984*, LC/G.1336 (Santiago, Chile, 1984), table 14.

After the economic crisis of 1982–1983 erupted, Latin America did not grow for the remainder of the 1980s. The region’s collective per capita GDP that decade fell more than 7 percent, while only three Latin American countries achieved positive GDP growth: Colombia, Chile, and Paraguay, in that order. Paraguay’s growth was insignificant, and none of these three countries came even close to 2 percent growth.²⁶ It should be emphasized that the rate of economic growth in Chile under the government of General Pinochet in the 1980s was not at all miraculous: the miracle was in a public relations success that consisted of convincing so many of Chile’s purported economic growth.

From 1973 until 2000, per capita GDP for the world economy grew at a pace of 1.3 percent per annum. The U.S. economy, based on this measure, grew almost 2 percent, compared to Latin America’s growth of almost 1 percent.²⁷ During this period, the gap between the United States and Latin America increased once again, and, when compared to its own history, the rate of growth in Latin America was the poorest since the 1870s. The growth of several countries in East Asia, despite the financial crisis of 1997 (and of other lesser financial crises in the preceding quarter century), was excellent. Growth of per capita GDP in those years was more than double that of the United States in China, Malaysia, Singapore, South Korea, Taiwan, and Thailand. The annual rate of growth also picked up in India and Sri Lanka, where it exceeded the growth rate of the U.S. economy.

How is this interruption in the growth of Latin American GDP explained? Latin America was able to grow during previous decades of growth of the world economy—the 1950s and 1960s—with various economic models, albeit suffering the problems of institutional, economic, and social design already mentioned. When the generalized growth of the world economy was interrupted in the 1970s, that previous benevolent international framework was also interrupted. The burden placed on economic growth by the bad decisions adopted in Latin America and by the possible good decisions that were deferred, as already summarized, was at long last clearly apparent.

With a delayed adjustment thanks to external indebtedness in the 1970s, impressive and persistent hindrances to international trade, the overvaluation of the exchange rate, mediocre investment in human resources, a limited domestic market punished by inequality and poverty, and, finally, an institutional rupture of the magnitude noted in the 1970s, the economic model of the 1950s and 1960s finally broke down in the 1980s.

As of the 1970s, Latin America faced a world economy that demanded greater participation in international trade in order to grow. With start dates that ranged from the 1980s to the 1990s, the countries of Latin America liberalized their foreign trade, but with major lags compared to the experiences of the already developed countries or the quickly developing countries of East Asia. The Latin American governments adopted reforms to their banking systems and modified their fiscal policies and exchange rates, but with the obvious inexperience of beginners.

In the 1980s, governments as diverse as those of Argentina, Brazil, Venezuela, and Peru adopted fiscal and exchange rate measures of such ineptitude that they guaranteed disastrous results. These countries' efforts at monetary stabilization without appropriate reduction of the fiscal deficit in so-called heterodox economic programs led to failures to abide by the governments' set economic policies, booms in the informal sectors of the economy, replacement of the ministers in charge of economic policy, and, especially in Argentina, Brazil, and Peru, extraordinary rates of inflation. In these countries, by 1989–1990, inflation exceeded 1,000 percent annually, which in turn fostered deep disillusionment with the government instead of citizens' jubilation over democratic progress.²⁸

The last two decades of the twentieth century were marked by repeated financial crises in Latin America. After the debt crisis of 1982, at least one other major financial debacle took place in Argentina, Brazil, Bolivia, the Dominican Republic, Ecuador, Mexico, Peru, and Uruguay, in addition to the continuation of the Central American wars until the early 1990s.

The cost of Latin America's procrastination in adjusting and implementing structural economic reforms delayed the region's potential to reap the benefits of the global economic boom sparked by the growth experienced in North America, Western Europe, and East Asia in the 1980s and 1990s. Under the tutelage of the International Monetary Fund, the process of adjustment and structural reform in Latin America during these two decades had, in general, a recessive bias in the region that weakened the recovery of its economic growth. Latin America was perhaps on the verge of its own economic take-off in the mid-1990s, but it was shaken once again when the economy of the already-developed countries and, more broadly, the international economy suffered another setback. The economic crisis of the East Asian countries in 1997, the stagnation of the Japanese economy in the 1990s, the slowdown of economic growth in Western Europe in

the late 1990s, and the recession in North America in the early 2000s drastically reduced external financing in Latin America. European investment was directed to the former communist countries of Central and Eastern Europe, and international investment from Japan and the United States dropped off. As a result of the new international economic pressures, a financial crisis erupted in Brazil in 1999, and the economy collapsed in Argentina at the turn of the twenty-first century. Bolivia, Ecuador, and to a lesser extent Uruguay suffered equally serious problems, including grave social and political crises in Bolivia and Ecuador.

Despite the varied reform programs that have been implemented in Latin America, much remains to be done. Consider, for example, a simple institutional indicator: the number of days required to start up a new business. As indicated in table 4.6, starting up a new firm is relatively simple in countries such as Australia, the United States, and Puerto Rico. Chile has amended its regulations so as to compete with the countries of East Asia. It is interesting and ironic that it is easier to open a new business in the People's Republic of China than in Mexico or Argentina, and three times easier in communist China than in Brazil. It should come as no surprise that the countries that facilitate the creation of new businesses, which generate employment and income, grow more.

There are, however, some positive cases in Latin America. Mexico's trade liberalization program, which allowed its subsequent entry to the North American Free Trade Agreement (NAFTA), generated quick growth in the sectors linked to the international economy. Despite

TABLE 4.6 Number of Days Required to Start Up a New Firm, 2003

Australia	2
United States	4
Puerto Rico	6
Chile	28
Japan	31
South Korea	33
Thailand	42
People's Republic of China	46
Mexico	51
Argentina	68
Brazil	152

Source: *World Development Indicators 2004* (Washington, DC: World Bank, 2004).

retaining a counterproductive exchange rate regime and other problems, Mexico's revolution in international trade in the 1990s rescued the country from its financial panic of 1994–1995, allowed it to grow at a fast pace during the second half of the 1990s for the first time in two decades and enabled it to survive the economic recession in the United States in the first years of the twenty-first century.

That very experience in Mexico, however, highlighted the legacies of the decisions that Latin America had put off earlier. Mexico and the rest of Latin America today can compete with the up-and-coming Chinese economy by reducing workers' wages, which already are not high, or by investing in human resources to bring about increased productivity. No one wants to pursue the first option, and the second one takes years to bear fruit. Argentina—a country long accustomed to a high level of consumption—is also facing that dilemma. Latin America could grow more if its domestic market were larger and if its citizens could contribute more to its economic growth. Yet income inequality (always neglected) and poverty (whose reduction has only received attention in recent years and only in some countries) reduce the real size of each domestic economy, and weak institutional frameworks hinder the coordination of efforts to foster economic growth.

Conclusion

The origins of the gap between the United States and Latin America date back centuries. Latin America's economic performance improved, however, during the period from 1870 to the early 1970s. Even during that century of better per capita GDP growth in Latin America, however, the region neglected to invest in human resources and to reduce inequality and poverty when compared to the gains made in the United States and in other countries that have successfully developed their economies. As the twentieth century advanced, there was a marked preference in Latin America for autarchic economic strategies, which were taken to extremes never seen in the countries of the North Atlantic or East Asia, and which experienced faster economic development. In addition, weak institutions in Latin America—a persistent problem—worsened even more in the 1970s. A terrible decade for the region, the 1970s witnessed unproductive, fleeting, and irresponsible sovereign indebtedness by governments, as well as the killing of thousands of citizens, instead of a reorganization of economic structures that would allow for a more felicitous shared prosperity.

The combination of pervasive neglect of necessary investment in human resources, dysfunctional institutions, and poorly designed and implemented economic measures, concomitant with the suicidal conduct of many of the region's governments in the 1970s, explains the interruption in the rate of growth of Latin America's per capita GDP and the severity of its economic depression in the 1980s. The much-delayed process of adjustment and structural reform—still incomplete, as illustrated in table 4.6—precluded Latin America from fully benefiting from the growth of the world economy in the 1980s and 1990s. The region's growth was further delayed by the international crises that unfolded at the turn of the twenty-first century.

There is no magic wand that will close the development gap between the United States and Latin America. The instruments for closing the gap are not new. No genetic injections or culturalist experiments are needed. Moreover, the military governments that presided earlier already proved their colossal ineptitude, which brought Latin America to the brink of the precipice in the 1970s and 1980s.

Looking to the future, there is a clear need in Latin America to increase investment in human resources. With a stronger population capable of building its own future, reliable institutions under a democratic political framework that can guarantee the rule of law are also needed. Promoting human development through sensible economic policies in a market economy framework makes the most sense. It is time for Latin America to stop ignoring the obvious next steps to take.

Notes

1. Sources for these and other statistics are Angus Maddison, *The World Economy: Historical Statistics* (London: Development Centre, OECD, 2003); and Angus Maddison, *The World Economy: A Millennial Perspective* (London: Development Centre, OECD, 2001).
2. John H. Coatsworth and Alan M. Taylor, *Latin America and the World Economy since 1800* (Cambridge, MA: Harvard University, David Rockefeller Center for Latin American Studies, 1998).
3. World Bank, *World Development Indicators 2004* (Washington, DC: World Bank, 2004), p. 61.
4. Werner Baer, *The Brazilian Economy: Growth and Development*, 5th ed. (Westport, CT: Praeger, 2001).
5. Calculations based on Maddison, *The World Economy: Historical Statistics*, tables 4b, 4c, 5b, 8c.
6. Sources on Central America are Victor Bulmer-Thomas, *The Political Economy of Central America since 1920* (Cambridge: Cambridge University Press, 1987); and Marc Lindenberg, "World Economic Cycles and Central American Political Instability," *World Politics* 42 (1990): 397–421.

7. Richard Weisskoff, "Income Distribution and Economic Growth in Puerto Rico, Argentina, and Mexico," *Review of Income and Wealth* 16, no. 4 (1970): 303–332.
8. Ricardo Ffrench-Davis, Oscar Muñoz, and José Gabriel Palma, "The Latin American Economies, 1950–1990," in *The Cambridge History of Latin America: 1930 to the Present*, vol. 6, part 1 (Cambridge: Cambridge University Press, 1994), table 4.3.
9. Calculations based on Maddison, *The World Economy: Historical Statistics*, tables 4c, 5c.
10. Ffrench-Davis, Muñoz, and Palma, "The Latin American Economies," table 4.6.
11. Dani Rodrik, "Understanding Economic Policy Reform," *Journal of Economic Perspectives* 34 (March 1996): 9–41.
12. Baer, *The Brazilian Economy*; and Alan M. Taylor, "On the Costs of Inward Looking Development: Price Distortions, Divergence, and Growth in Latin America," *Journal of Economic History* 58 (March 1998): 1–28.
13. Alexander Gerschenkron, *Economic Backwardness in Historical Perspective* (Cambridge, MA: Harvard University Press, 1962).
14. Chalmers A. Johnson, *MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925–1975* (Stanford, CA: Stanford University Press, 1982).
15. Robert Floyd, Clive Gray, and R. P. Short, *Public Enterprise in Mixed Economies* (Washington, DC: International Monetary Fund, 1984).
16. Alice H. Arnsden, *The Rise of "the Rest": Challenges to the West from Late Industrializing Economies* (Oxford: Oxford University Press, 2001).
17. Jeffrey D. Sachs, "External Debt and Macroeconomic Performance in Latin America and East Asia," *Brookings Papers on Economic Activity* 2 (1985): 523–573.
18. Stanley L. Engerman and Kenneth L. Sokoloff, *Factor Endowments, Inequality, and Paths of Development among New World Economies*, Working Paper 9259 (Cambridge, MA: National Bureau of Economic Research, 2002).
19. All currency amounts are in U.S. dollars unless otherwise noted. World Bank, *World Development Indicators 2004*, p. 54.
20. Douglass C. North, *Institutions, Institutional Change, and Economic Performance* (Cambridge: Cambridge University Press, 1990).
21. Calculations based on Bulmer-Thomas, *The Political Economy of Central America since 1920*, table A.3.
22. Maddison, *The World Economy: Historical Statistics*.
23. Cited by Jorge Chabat, "Mexico's Foreign Policy in 1990: Electoral Sovereignty and Integration with the United States," *Journal of Interamerican Studies and World Affairs* 33, no. 4 (1991): 12.
24. Argentina's exceptional status is evident in an international comparison on democracy and development. See Adam Przeworski, Michael Alvarez, José Antonio Cheibub, and Fernando Limongi, *Democracy and Development: Political Institutions and Well-Being in the World, 1950–1990* (Cambridge: Cambridge University Press, 2000).
25. Gretchen Helmke, *Courts under Constraints: Judges, Generals, and Presidents in Argentina* (Cambridge: Cambridge University Press, 2005).
26. United Nations, Economic Commission for Latin America and the Caribbean (ECLAC), *Preliminary Overview of the Economy of Latin America and the Caribbean, 1990*, LC/G.1646 (Washington, DC: ECLAC, 1990), table 3.
27. Maddison, *The World Economy: Historical Statistics*, table 8b.
28. ECLAC, *Preliminary Overview of the Economy 1990*, table 5.