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New Institutional Economics: Political Institutions and Divergent Development in Costa Rica and Honduras

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An Honors Paper for the Department of Economics

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Abstract

For most of their histories, Costa Rica and Honduras were primarily agricultural societies with little economic diversification. However, around 1990, after the implementation of Washington Consensus reforms, the economies of both nations began to diverge. Costa Rica's economy rapidly expanded for the following 30 years, while Honduras remained stagnant. Through a New Institutional Economics approach, I argue that institutional differences between Costa Rica and Honduras are responsible for the impressive economic growth Costa Rica has been able to achieve in the past few decades. Specifically, early political developments in Costa Rica have deeply imbedded relatively egalitarian values into the population, helping shape formal and informal inclusive political institutions. Meanwhile, Honduras experienced the development of extractive political institutions, as political and economic power was heavily concentrated in the hands of a select few. These political institutions were crucial during the implementation stages of Washington Consensus reforms, as strong and inclusive political institutions attracted Foreign Direct Investment that helped propel the Costa Rican economy and materialize its position as an outlier in the region. In contrast, lack of institutional guarantees discouraged foreign investors from investing money into the Honduran economy. Through a deep dive into the political histories of both nations, from European discovery to modernity, I conclude that the political institutions of these Central American nations have determined their economic growth paths.

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I would like to thank my parents, who instilled their intellectual curiosity and love for Central America deep in me. I would also like to thank my grandmother, who serves as a role model for me in my studies and life. Lastly, I would like to thank all my friends, as well as the faculty and staff at Bowdoin College, who have been instrumental in the development of this honors thesis. It could not have been possible without your help.

Ultimately, I would live to dedicate my honors thesis to the people of the Global South, particularly to those hailing from Central America who have been abandoned by the developed world. My work in this thesis delves into their everyday realities, one which I am removed from. Hopefully in the near future, lawmakers can finally begin crafting sustainable solutions to uplift their lives and truly enter a new 'age of development.'

Introduction

> We're so high on progress that we allow a tiny segment of the population to create the narratives of our world.
>
> Ailton Krenak[1]

Economic thought has long considered the question: how can a society best achieve economic growth? With the expansion of colonialism and imperialism, the birth of mercantilism and capitalism came about, challenging the feudalistic status quo of Europe prior to the discovery of the New World. With the expansion of Europe across the world, a new age of development ensued, bringing great fortunes to the colonial powers and inadequate outcomes for the overexploited colonies. It it interesting that it is during this 'age of development' and advancing capitalism that inequalities between nations began to develop.[2] Stark economic divisions would soon be seen between the colonial powers and post-colonial Latin American nations. After the fall of European colonialism in Latin America in the early 19th century, inhabitants of the New World began to wonder how they, like Europe, could achieve economic development. Rather than seeking to come up with their own solutions to the development question, Latin American post-colonial nations continued the European capitalistic economic system where exclusion was the norm. Seeking to protect the material interests of the landed descendants of the *conquistadores*, national governments worked, for the most part, for the landed aristocracy rather than most of the population.

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[1] Ailton Krenak, *Ideas To Postpone The End of The World* (Toronto, Canada: Anansi International, 2020), 2.
[2] Joel Wainwright, *Deconolonizing Development: Colonial Power and the Maya* (Malden, MA: Blackwell Publishing, 2008), 1–2.

This was the context in which Central America, the region between Mexico and Colombia, was colonized, achieved independence, and founded independent nations. This honors project will primarily follow the political and economic development of two Central American nations: Costa Rica and Honduras. Both nations were colonized by the Spanish Empire, gained independence in 1821, became independent nations in 1841, have similar natural endowments, and are in the same geographic region. For most of their histories, Costa Rica and Honduras performed similarly in an economic sense, enjoying similar Gross Domestic Products. By the 1980s, both nations still enjoyed similar GDPs and standards of living. However, by 1990, an economic divergence began to occur as Costa Rica experienced rapid and sustained economic growth, while Honduras remained relatively poor. By 2020, Costa Rica's GDP was about 2.5 times the size of Honduras' GDP. With these nations' similarities in mind, this honors project seeks to answer the following questions: (1) Why did the 1990 economic divergence occur? and (2) What is the role of political institutions in the economic development paths of both nations?

Employing a New Institutional Economics approach to the questions at hand, I propose that institutional differences between Costa Rica and Honduras are the root cause for the 1990 economic divergence and the present inequalities between both nations. Since the establishment of its independent government, Costa Ricans have valued compromise among social classes, especially after the introduction of coffee for commercial purposes in the 1830s, creating an informal institutional norm since the early beginnings of the country. This early informal institutional norm was critical in the formation of a relatively egalitarian political and economic structure in 19th century for Costa Rica, which deeply influenced the nation's 20th century institutions. Unlike Costa Rica, Honduras' early political and economic structures sought only to benefit the landed elite, ignoring most of the nation's population. The connections between the landed elite and politicians eventually led to the creation of a network of corruption that involves the nation-state, political parties, and the country's elite. The formation of this institutional structure in the 19th century still lingers today, as Honduras continues to be a vastly corrupt nation. These nations' 19th century institutions deeply influenced their 20th century institutions, as institutions slowly evolve and are responsive to endogenous and exogenous shocks. In the 20th century, Costa Rica's relatively egalitarian institutions, which developed from those of the 19th century, were crucial in the success of the Washington Consensus policies, which helped the nation achieve impressive economic growth after 1990. However, Honduras' web of corruption continues to pose significant challenges for the nation-state, which is a direct benefactor of the network. It is because of the institutional differences between Costa Rica and Honduras that Costa Rica was able to achieve significant economic growth after 1990, while Honduras remained mostly stagnant.

It is from the recognition that 'poor' nations are often cornered by the International Monetary Fund and the World Bank that the inspiration for this honor thesis arises. Better models of development must be designed by the leaders of these multilateral financial organizations for nations to truly achieve 'development.' With the continued application of one-size-fits-all solutions, the IMF and the World Bank are effectively continuing the cycle of dependence of the Global South on financing from the Global North. Rather, these organizations should work with 'developing' nations to craft solutions that consider local context and local institutions into their economic plans. After all, I conclude that institutions do indeed trump everything else. Institutional differences were crucial to the economic divergence between Costa Rica and Honduras, and these institutional differences can provide some insights for policymakers who seek to bring robust and sustained economic growth to their respective nations. I also provide insights into other pertinent question in the economic literature. Specifically, I provide insights on the following questions: (i) Were the Washington Consensus policies of the 1990s successful? (ii) Is there a 'correct' way for a country to develop economically? and (iii) Can nations achieve economic success today without the support of the United States, the World Bank, and the International Monetary Fund?

The honors thesis is organized as follows: Chapter 1 provides a literature review on growth theory and New Institutional Economics. Chapter 2 gives an overview of the political economy of Central America. It delves into Central American history from its discovery through the establishment of the Federal Republic of Central America in 1821. After, brief histories are provided for Costa Rica and Honduras, the two countries of interest. Chapter 3 highlights the economic downturns of the Lost Decade and the subsequent economic policies sponsored by Washington-based multilateral financial organizations, later to become known as the Washington Consensus. The chapter ends with the 1990 economic divergence between Costa Rica and Honduras. Chapter 4 connects Costa Rica's and Honduras' political and economic histories through a New Institutional Economics framework, arguing that the institutions of the respective nation has deeply impacted their respective growth paths. China's rise to world economic power is considered as a criticism against New Institutional Economics. Chapter 5 provides econometrics complement to the New Institutional Economics framework of the previous chapter. It concludes that institutions do drive economic growth, obtained from running regressions of GDP data on institutional strength estimators. Chapter 6 contains some final remarks on Costa Rica, Honduras, New Institutional Economics, as well as some policy recommendations and ideas for future research.

Literature Review

Three primary schools of thought exist in the economic growth literature: geography, integration, and institutions. The geography camp, advocated by economists like Jeffrey Sachs, believes that differences among countries in the long-run growth of output is determined by the endowment of natural resources, climate, and disease, among other determinants that are more or less geographically fixed. The integration camp emphasizes the role that international trade plays as a driver of productivity growth and integration into the world markets. Finally, the institutions camp emphasizes the role that political and economic institutions play in a country's economic development.[3] It must be noted that the institutional economics camp was born in the 1990s and is still rather in its early stages of development. The New Institutional Economics school was born out of countries' frustrations with the Washington Consensus policies of the 1990s, put forward by high income countries of North America and Europe and multilateral lenders controlled by the Global North.[4]

An alternative clearly needed to be provided for economic development, especially as some countries were able to succeed with Washington Consensus policies while others stayed behind. John Williamson, who coined the term Washington Consensus, writing in retrospect, recognized that "the progress of development economics in the 1990s led to a major focus on the importance of institutional reforms, which were simply not on the agenda in 1989, when all the concern was with reforming policies. The Washington Consensus was a product of its time, and so there was little recognition of institutional issues." [5] From the recognition that an alternate

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[3] Dani Rodrik, Arvind Subramanian, and Francesco Trebbi, "Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development," *Journal of Economic Growth* 9, no. 2 (2004): 132.
[4] John Williamson, "The Strange History of the Washington Consensus," *Journal of Post Keynesian Economics* 27, no. 2 (Winter -2005 2004): 199.
[5] Williamson, 199.

camp to the traditional economic growth schools of thought was needed in the 1990s, much research has been done to assess the relationship between institutions and economic growth. For example, Rodrik, Subramanian, and Trebbi conduct a study where they assess the role institutions play in economic development, while controlling for geography and trade. They ultimately conclude that the quality of institutions 'trumps' everything else, as, after institutions are controlled for, geography has weak direct effects on income, and trade is almost always insignificant.[6] In their paper, the authors do recognize that estimating institutional quality is a challenge, as there is no right way to measure institutional quality and the right proxy does not exist either. For example, they point out that Acemoglu et al. (2001) assessed institutional quality by using the mortality rates of colonial settlers as a proxy variable.[7] Furthermore, they recognize that institutionalists need to worry about reverse causality. Specifically, institutionalists need to show that better property rights, or better rule of law, for example, are independent determinants of incomes, and not just a consequence of higher incomes.[8]

A number of authors have delved into the arguments put forward by New Institutional Economics. Primarily, Douglass North has worked extensively since the 1990s to explain the theoretical framework of the New Institutional Economic literature, seeking to explain the connections between political institutions and economic growth. From his early contributions, others have been able to quantitatively assess the relationship between political institutions and economic development. For example, Easterly and Levine (2003), drawing on a sample containing 72 countries, ultimately concludes that institutions exert an important effect on

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[6] Rodrik, Subramanian, and Trebbi, "Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development," 131.
[7] Daron Acemoglu, Simon Johnson, and James A. Robinson, "The Colonial Origins of Comparative Development: An Empirical Investigation," *The American Economic Review* 91, no. 5 (December 2001): 1370.
[8] Rodrik, Subramanian, and Trebbi, "Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development," 134.

economic development. Specifically, they assert that if Mexico were to improve its level of institutional development to the level of the United States' institutional quality, the GDP per capita gap between the two countries would be eliminated.[9] Furthermore, Engerman and Sokoloff (2004) suggest that political institutions have shaped the economic development of the United States and Canada relative to the rest of the New World, as both nations have been able to achieve vast economic growth because of their governmental structures.[10]

While research on institutions has been undertaken by a variety of authors, the most important contributions to the field of New Institutional Economics have been provided by Daron Acemoglu and James Robinson. In their book *Why Nations Fail,* Acemoglu and Robinson explored the role institutions play in the economic development of nations. The authors ultimately conclude that countries either succeed or fail due to their political institutions, as "it is the political process that determines what economic institutions people live under." [11] Acemoglu and Robinson make a distinction between extractive and inclusive political institutions. Extractive political institutions concentrate power in the hands of a few elites and has few constraints on their power. Extractive economic institutions are likewise built by the elites to extract resources from society. In contrast, inclusive political institutions distribute political power throughout society, preventing a concentration of power and wealth at the hands of a select few.[12] The distinction between political institutions is of utmost importance to the argument put forward by Acemoglu and Robinson. Specifically, they conclude that nations with

[9] William Easterly and Ross Levine, "Tropics, Germs, and Crops: How Endowments Influence Economic Development," *Journal of Monetary Economics* 50, no. 1 (January 2003): 32.
[10] Stanley L. Engerman and Kenneth L. Sokoloff, "Factor Endowments, Institutions, and Differential Paths of Growth Among New World Economies: A View from Economic Historians of the United States," in *How Latin American Fell Behind: Essays on the Economic Histories of Brazil and Mexico, 1800-1914* (Stanford, CA: Stanford University Press, 1997), 281.
[11] Daron Acemoglu and James A. Robinson, *Why Nations Fail* (New York, NY: Crown Publishers, 2012), 42.
[12] Acemoglu and Robinson, 81.

inclusive institutions, where political and economic power are evenly distributed throughout society, will achieve economic growth, unlike nations with extractive political institutions.

The authors provide extensive historical evidence to back up their claims. At the beginning of their book, they consider the experience of one specific region, Nogales in the United States-Mexico border. Nogales, Arizona in the United States and Nogales, Sonora in Mexico are border towns encompassing the same area, solely separated by the U.S. - Mexico border. Northern Mexico, albeit richer than most of the country, still does not offer the same economic and professional opportunities presented to the people of Nogales, Arizona.[13] According to Acemoglu and Robinson, Nogales can tell us a story that goes beyond a city separated by a physical national border. Rather, the two parts of Nogales can explain the unequal world we reside in, as "In rich countries, individuals are healthier, live longer, and are much better educated. They also have access to a range of amenities and options in life, from vacations to career paths, that people in poor countries can only dream of…Notable, too, is the fact that the citizens vote in elections and have some voice in the political direction their countries take." [14] Acemoglu and Robinson conclude that Nogales, Arizona is much richer than Nogales, Sonora because of the very different institutions found in both places. The different institutions across the border create different economic incentives for the citizens of both cities, as citizens are subject to the political process of their community.[15] Under the inclusive political institutions of Nogales, Arizona, it might be easier to obtain licenses to open a new business or secure financing, whereas the extractive political institutions of Sonora might prevent non-elites or those lacking significant capital from doing so. In this sense, the extractive political institutions

[13] Acemoglu and Robinson, 41.
[14] Acemoglu and Robinson, 41–42.
[15] Acemoglu and Robinson, 42.

of Sonora prevent the city of Nogales from achieving an economic prosperity similar to that of Nogales, Arizona.

Acemoglu's and Robinson's arguments in *Why Nations Fail* do not only apply to the Nogales example they provide. Rather, history provides several examples where regions develop vastly differently due to the political systems they develop. For example, the development of East and West Berlin after World War II is evident, with West Berlin resembling the great cities of the Western World, while East Berlin remained stuck in a historical bubble. Decades after the fall of the Berlin Wall, Germany still faces some struggles with the unification of its capital city, as the vast differences in political administration are clearly resembled in the cityscape and its amenities.[16] To provide a more modern example, one can look at the two Koreas. After the Korean War, North Korea and South Korea have followed vastly different development paths as a result of their political systems. North Korea, under authoritarian rule, has suffered from famines, economic crises, and is considered a pariah state by most of the civilized world. [17] [18] [19] In contrast, South Korea has developed into an economic powerhouse and regional hub in East Asia, mostly due to its impressive economic growth in the latter part of the 20th century.[20] The question then becomes, if both nations were once the same nation-state, how can it follow that after separation one country has succeeded and the other has not?

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[16] Emma Hartley, "How Astronaut Chris Hadfield Showed Berlin's Ongoing Struggle for Unification," *The Guardian*, April 21, 2013, https://www.theguardian.com/world/shortcuts/2013/apr/21/astronaut-chris-hadfield-berlin-divide.

[17] Laura Bicker, "As Winter Looms, Reports of Starvation in North Korea," *BBC News*, November 5, 2021, https://www.bbc.com/news/world-asia-59144712.

[18] Justin McCurry, "North Korea Faces Economic Ruin amid Food and Medicine Shortages," *The Guardian*, May 4, 2021, https://www.theguardian.com/world/2021/may/05/north-korea-economic-crisis-food-and-medicine-shortages-covid.

[19] "Obama Brands North Korea a 'Pariah State,'" *Al Jazeera*, April 26, 2014, https://www.aljazeera.com/news/2014/4/26/obama-brands-north-korea-a-pariah-state.

[20] Sam Kim, "South Korea Eyes Rich Nation Status as Economy Holds Up," *Bloomberg LLC*, January 24, 2021, https://www.bloomberg.com/news/articles/2021-01-25/korea-eyes-rich-nation-status-as-economy-holds-up-amid-pandemic.

The two Central American nations considered in this paper, Honduras, and Costa Rica, like North and South Korea, were once part of the same nation-state. In 1821, Central America (modern day Guatemala, Honduras, El Salvador, Nicaragua, and Costa Rica) declared independence from the Spanish Crown and officially became the Federal Republic of Central America. However, after years of political infighting and instability, in 1841, the Federal Republic of Central America dissolved, and the five Central American nations were established.[21] Centuries after the demise of the Federal Republic, Central American nations have undergone multiple historical events which have impacted their development prospects. Some have experienced civil unrest, some natural disasters, others, mass outflows of refugees. Yet, the one nation throughout the last half a century that has fared better than all has remained consistent, Costa Rica. Similarly to South Korea, Costa Rica has managed to become an outlier in its region, outperforming growth prospects and defying the region's propensity for instability. Costa Rica is not to be recognized solely for its economic prowess, but also for its democratic essence, as it is the region's only country to maintain continuous democratic rule since 1949.[22] Applying Acemoglu's and Robinson's conclusions, could it be that the stronger political institutions of Costa Rica, like those of West Germany and South Korea, have helped the nation succeed economically relative to its poverty-stricken peers?

By conducting extensive research into the political development of nations, Acemoglu and Robinson further point out that countries commonly do not adopt institutions that are best suited to bring economic growth or bring forth the most welfare to its citizens, but instead those

[21] William F. Slade, "The Federation of Central America," *The Journal of Race Development* 8, no. 1 (July 1917): 79.
[22] Maria Sada, "The Curious Case of Costa Rica: Can an Outlier Sustain Its Success?," *Harvard International Review* 36, no. 4 (Summer 2015): 11.

that most benefit the people holding the reins of government.[23] The rent-controlling elite succeed politically and remain in power in nations with underdeveloped political and economic institutions. Specifically, "powerful groups often stand against economic progress and against the engines of prosperity… Growth thus moves forward only if not blocked by the economic losers who anticipate that their economic privileges will be lost and by the political losers who fear that their political power will be eroded." [24] This seems to be the norm rather than the exception in the developing world. Specifically, Honduras has had several presidents and high-ranking government officials who have engaged in narcotrafficking and other corrupt and illegal acts. Most recently, former Honduran President Juan Orlando Hernandez was arrested on narcotrafficking charges shortly after finishing his term as President.[25] However, while Juan Orlando Hernandez was arrested at the conclusion of his term and once he no longer enjoyed presidential immunity, accusations of narcotrafficking and corruption had plagued his administration for years.[26] Therefore, we can begin to see that Honduras, as a nation with underdeveloped and extractive political and economic institutions, fits well into the portrait painted by Acemoglu and Robinson regarding corrupt leaders who seek their own enrichment rather than the general welfare of their country's population. Meanwhile, Costa Rica, while it does face some challenges, for the most part enjoys inclusive political institutions that prevent the concentration of political and economic power in the hands of a select few. It is because of an institutional divergence between both nations around 1990 that Costa Rica was able to achieve

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[23] Acemoglu and Robinson, *Why Nations Fail*, 44.
[24] Acemoglu and Robinson, 86.
[25] Joan Suazo and Anatoly Kurmanaev, "Former Honduras President Detained After a U.S. Extradition Request," *The New York Times*, February 15, 2022, https://www.nytimes.com/2022/02/15/world/americas/honduras-president-juan-orlando-hernandez-detained.html.
[26] Emily Palmer and Kirk Semple, "A Damning Portrait of Presidential Corruption, but Hondurans Sound Resigned," *The New York Times*, March 23, 2021, https://www.nytimes.com/2021/03/23/world/americas/honduras-juan-orlando-hernandez-drug-trial.html.

significant and sustained economic growth, while Honduras continued to struggle.

Acemoglu's and Robinson's contributions to New Institutional Economics are crucial to the arguments made in this thesis, as I take their contributions as a starting point to explore the institutional differences between Costa Rica and Honduras in a quest to explain their divergence in economic growth. Given the three traditional schools of thought aforementioned, it must be noted that Acemoglu and Robinson likewise point out other potential theories that scholars have cited as a reason for economic development. One of the primary theories the scholars address is the culture hypothesis for economic development. Tracing back its origins to German sociologist Max Weber, the culture hypothesis claims that the Protestant Reformation and the Protestant work ethic played a key role in the rise of modern industrial society in Western Europe.[27] While this hypothesis would likely not hold up today in scholarly debate, it is still a view held by many. Yet, the theory does not apply to Central America, especially focusing on Honduras and Costa Rica, which share a similar culture and history tracing back to the Spanish Empire. Yet, even with similar cultural values, Costa Rica has managed to grow at an unprecedented rate, rather than stagnate economically, as the proponents of the culture hypothesis would likely claim.

Another theory Acemoglu and Robinson address is the ignorance hypothesis. This hypothesis, tracing back its definition to the English economist Lionel Robbins, claims that the rulers of poor countries simply do not know how to make their countries rich.[28] Today, this is a view held by most economists. For example, former chief economist of the World Bank and Nobel Laureate Joseph Stiglitz has claimed repeatedly that poor countries "are poor because their leaders have only half-heartedly implemented sensible economic ideas." [29] Yet, Acemoglu and

[27] Acemoglu and Robinson, *Why Nations Fail*, 57.
[28] Acemoglu and Robinson, 63–64.
[29] Bruce Bueno de Mesquita and Hilton L. Root, "The Political Roots of Poverty: The Economic Logic of Autocracy," *The National Interest* 68 (Summer 2002): 29.

Robinson argue “if ignorance were the problem, well-meaning leaders would quickly learn what types of policies increased their citizen’s incomes and welfare, and would gravitate toward those policies.” [30] It seems rather intuitive that this theory likewise does not explain the economic divergence between Costa Rica and Honduras. After all, Honduran and Costa Rican leaders have access to technocrats trained at top U.S. and world universities. The current President of the Central Bank of Costa Rica, Rodrigo Cubero Brealey, is an Oxford-trained economist and held a senior position in the International Monetary Fund.[31] Whether the leaders follow or listen to policy recommendations is another question. Therefore, the ignorance hypothesis does not hold up, as “the adoption of policies that would reduce market failures and encourage economic growth is not the ignorance of politicians but the incentives and constraints they face from the political and economic institutions in their societies.” [32]

Given the theories that have been offered by multiple scholars, most, if not all, fall flat in explaining economic growth of not only Costa Rica and Honduras, but rather multiple other examples throughout history. The traditional schools of thought in economic development, geography and integration, as well as the two theories highlighted by Acemoglu and Robinson, culture and ignorance, do not seem to explain the economic development of Costa Rica relative to Honduras, West Berlin relative to East Berlin, nor South Korea relative to North Korea. While each example is unique and economists must not apply one size fits all solutions, it is safe to say that new ways of explaining economic development must be given consideration. Institutions, particularly political institutions, provide an encompassing economic explanation for why some

[30] Acemoglu and Robinson, *Why Nations Fail*, 65.
[31] “Oxford Graduate Appointed President of the Central Bank of Costa Rica” (Oxford, UK: University of Oxford, June 1, 2018), https://www.lac.ox.ac.uk/article/oxford-graduate-appointed-president-of-the-central-bank-of-costa-rica.
[32] Acemoglu and Robinson, *Why Nations Fail*, 67.

countries develop while others stay behind. Specifically, political institutions can provide an explanation for the economic divergence between Costa Rica and Honduras.

Political Economy of Central America

Discovery, Early Settlement, and Colonial Rule

The Central American region, located between North and South America, has been subject to a riveting history. Originally under the control of the Spanish Empire, the region was controlled by the Spanish Crown from its discovery in 1502 to independence in 1821. Since the arrival of Christopher Columbus to Cabo Gracias a Dios in modern day Nicaragua in 1502, the region was an early disappointment to explorers and colonists. Wealth was easily acquired in Mexico or Peru relative to Central America, mostly due to their vast gold reserves and significant native populations, so early colonial trade routes developed between the empire and its sources of wealth rather than with the isolated Central American region.[33] The lack of early trade routes and material wealth resulted in a region rather isolated within the expansive and growing Spanish Empire in the Americas.[34] Nonetheless, even with early challenges, the region was able to grow economically and provide a suitable place for dedicated colonists to settle.

After discovery and early settlement, especially during the sixteenth and seventeenth centuries, the early economies of Central America primarily centered around the exploration and development of trade routes and agriculture. The development of trade routes, primarily in Panama and Nicaragua, was primarily due to their potential to create a physical link between the Pacific and Atlantic oceans, in the hopes of creating transisthmian trade routes linking Spain to Peru. Other areas of the region, not suitable for transoceanic trade routes, like Guatemala and Honduras, specialized in stock raising, eventually becoming the dominant economic activity of those respective countries. Furthermore, in El Salvador, cash crops became the primary source of

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[33] Steve C. Ropp and James A. Morris, eds., *Central America: Crisis and Adaptation* (Alburqueque, New Mexico: University of New Mexico Press, 1984), 9.
[34] Ropp and Morris, 10.

economic activity.[35] Thus, Central America, from its beginnings, had the potential to develop economically throughout its history albeit its poor location and relative lack of mineral resources.

Under Spanish control, Central America remained mostly an agricultural society, with its primary commodities being cash crops. After the introduction of indigo and cotton, a change in the social structures of Central America started to occur. Prior to the introduction of cash crops for trade, most Central Americans engaged in subsistence farming, only providing for themselves and their families. However, with the introduction and dominance of indigo and coffee for commercial purposes, the poor became poorer and a select few saw their estates grow significantly. Specifically, early settlers and those who gained the favor of the crown established vastly expansive estates, capturing most of the wealth produced in their respective areas. Together with a rise in their wealth, the landed elite soon became powerful political figures, eventually leading to the domination of Central American politics by a select few agricultural elite.[36] However, the economic and political systems established by the Spanish started to crumble in the early 19th century. Locals, under the inspiration of newly independent nations like the United States and the Mexican Empire, started to spread hopes of independence for the Central American region. In the latter part of Spanish rule in Central America, the Spanish centralized regional control in Guatemala, naming Guatemala City the colonial administrative center for the region.[37] As a result, the gains from agriculture and its trade primarily funneled into Guatemala City, leaving regional elites in other areas with severe economic losses. Some non-Guatemalan regional elites even lost their landholdings to Guatemalan creditors.[38] Frustrations with unjust taxation, social structures, and autonomy were just some of the reasons

[35] Ropp and Morris, 11.
[36] Bert F. Hoselitz, "Economic Development in Central America," *Weltwirtschaftliches Archiv* 76 (1956): 272.
[37] Ropp and Morris, *Central America: Crisis and Adaptation*, 12.
[38] Ropp and Morris, 12–13.

why many in Central America desired independence from the Spanish Crown. However, the economic and political considerations of declaring independence were monumental for the colonial elite of the region. Risking a potential war with Spain, alongside possibly losing the region's biggest trading partner were just some of the risks the colonial elites took on when deciding whether to declare independence.[39] Ultimately, the rewards outweighed the risks.

Independence, Political Infighting, and Early Political Development

In 1821, Central America declared independence from the Spanish Empire, forming an ill-fated alliance with Mexico that lasted two years. The alliance was ill-formed as independent Central American elites were politically and economically unprepared to govern the remnants of the Spanish Empire in the midst of a widespread economic depression.[40] The legacies of Guatemala's localism and influence did not die out with the Spanish Empire, rather it created the foundations for the alliance with the Mexican Empire. One may question why Central America formed an ill-fated alliance with the Mexican Empire rather than establish its own independent Republic. The reality is that Central American elites were simply unprepared to lead on their own right, as Central America, unlike other Latin American colonies, did not have to fight for its independence from the Spanish Crown, thus it did not have time for the creation of a national identity nor much political development.[41] Central America's lack of political development and national identity likewise led to the failure of the alliance with Mexico. Regional governments within Central America disagreed heavily on the issues, especially regarding the centralization of government structures within the region and how this would fit into the alliance with the

[39] Ropp and Morris, 13.
[40] Ropp and Morris, 13.
[41] Ropp and Morris, 13.

Mexican Empire.[42] Eventually, the rivalries between local governments heavily impeded the alliance with Mexico, thus Central America dissolved the alliance. After the dissolution of the alliance with Mexico, a constitution was drafted, and the Federal Republic of Central America was formed in 1823. However, the Federal Republic rapidly faced various crises, ranging from rising government debts, low and inconsistent tax revenues, and the ever-present threat of a Spanish invasion.

The foundations of the Federal Republic of Central America came with a myriad of issues. Primarily, when the Republic achieved independence from Spain and then Mexico, "it was an almost totally agricultural country with almost no contact with the world economy at large, with a poor, mostly illiterate population, lacking the most essential skills and engaged for the largest part in subsistence agriculture." [43] Yet, with the lack of economic diversification and poor growth prospects, a select few succeeded in Central America, controlling the economy and politics. The interests of the landed elite were of paramount importance, as wealth, political power and education were a monopoly of a small class of people. As a result of the monopoly on wealth and political influence, it was not hard for the landed elite to develop an ideology which centered their material interests. Specifically, the landed elite pursued policies based on the belief that "what was good for them was good for the nation." [44] The economic activities of the region after the establishment of the Federal Republic continued to center on agriculture. Specifically, between 1821 and 1825 the trade of agricultural products almost doubled, and the economic prospects for the region were good. In 1825, it was estimated that the Federal Republic's total value of exports was 8.25 million pesos, where indigo accounted for 2 million,

[42] Ropp and Morris, 13.
[43] Hoselitz, "Economic Development in Central America," 271.
[44] Hoselitz, 272.

cochineal 2.5 million, cocoa 1.5 million, gold and silver 1 million, and balsam 200,000 pesos. The remaining exports were other agricultural products and minerals.[45] Most agricultural products found markets in Europe, and most manufactured products were imported from Britain and other European countries.

During the early years of the Federal Republic, the United States started to assume a greater role in the protection of the Western Hemisphere hoping to safeguard its economic and political interests. Specifically, with the creation of the Monroe Doctrine, the United States sought to protect its interests in the Western Hemisphere, including all Latin America, from the threats of European colonialism. The primary goals of the Monroe Doctrine were the non-colonization principle denying Europe from continuing colonizing the Americas, abstention from European conflicts, and a commitment to respect independent nations' autonomy.[46] Much of the political rhetoric at the time among American officials centered around Napoleon's advances in Europe and the possible reintroduction of the Spanish Empire in the Americas. As a result, the United States chose to pursue a defined foreign policy to the Americas, where it swore to protect its independence from European colonialism.[47] However, that is not to say that some Americans did not venture out into Latin America in search of fortune. Throughout the early to middle parts of the 19th century, multiple Americans ventured into Central America in hopes of finding viable water sources for the construction of an interoceanic canal connecting the Pacific and Atlantic Oceans.[48] While the United States did not encourage these actions as a nation, American excursions into the Central American region could be interpreted as foreigners denying Central

[45] Hoselitz, 274.
[46] Samuel Flagg Bemis, *John Quincy Adams and the Foundations of American Foreign Policy* (Westport, CT: Greenwood Press, 1949), 363.
[47] Flagg Bemis, 388–90.
[48] H.R. Haar, "The Nicaragua Canal Story," *The Military Engineer* 48, no. 323 (1956): 189.

America its autonomy in its early formation, preventing it from political development and economic growth.

Disagreements between the two primary political parties of the Federal Republic, the Liberals and the Conservatives, eventually led to a series of civil wars between 1826 and 1829.[49] Deep disagreements over the centrality of power, much like the early debates on federalism in the United States, were central to the early formation of political thought in the region. The Conservatives desired a strong central government situated in Guatemala City, with little autonomy granted to the different subregions within Central America. The Liberals, on the other hand, desired a federation with more autonomy for the subregions with the hopes of diluting Guatemala's monopoly on political power, commerce, and education.[50] However, federalism was not the only hotly debated issue in the early years of the Federal Republic. Rather, Conservatives and Liberals clashed over a myriad of issues, including "Church-State relations, fiscal policies, officeholding, economic planning, trade policy, and general philosophy of government." [51] Ultimately, due to years of political instability and profound political disagreements, the Federal Republic did not last long, officially dissolving in 1841 and giving rise to the five modern Central American nations: Guatemala, El Salvador, Honduras, Nicaragua, and Costa Rica.[52]

After the dissolvement of the Federal Republic of Central America, caudillo politics became common in the region, becoming institutionalized into the political structures of the region. Caudillo politics are characterized by the presence of a strongman autocratic leader, often a member of the military or backed by the armed forces.[53] It is important to note that even after

[49] Ropp and Morris, *Central America: Crisis and Adaptation*, 13.
[50] Ropp and Morris, 13.
[51] Ralph Lee Woodward, *Central America: A Nation Divided*, Third (Oxford, UK and New York, NY: Oxford University Press, 1999), 92.
[52] Slade, "The Federation of Central America," 79.
[53] Roger M. Haigh, "The Creation and Control of a Caudillo," *The Hispanic American Historical Review* 44, no. 4 (November 1964): 481.

the dissolvement of the Federal Republic, some Central American nations again tried to form a federation. Most notably, Nicaragua, Honduras, and El Salvador established the United Provinces of Central America via the Pact of Chinandega in 1842. However, it ultimately failed.[54] Other Central American nations, particularly Guatemala and Costa Rica, decided to isolate themselves and establish their own independent governments free from any federation.[55] One central aspect of the caudillo governments of Central America was that, unlike in the United States or any other newly independent nation of the New World, political violence and brute force became accepted as a legitimate form of political discourse. Brute force in domestic politics became the norm in Honduras, El Salvador, and Nicaragua in the early beginnings of these newly independent nations, whereas Guatemala and Costa Rica experienced less instability due to their respective isolations and refusal to form part of any federation after the failures of the Federal Republic.[56]

Since the establishment of the Monroe Doctrine in 1823, the United States adopted a rather observant role to the affairs of the newly independent nations. However, that did not necessarily translate into Americans denying themselves the manifest density they thought they possessed, rather pursuing wealth from actively participating in the invasion of foreign nations with whom the United States was at peace with. For example, William Walker, an American filibuster, invaded Nicaragua and declared himself President of the independent nation in 1857. Walker's goals included the annexation of Nicaragua, and other Central American nations, to the United States, in the hopes of creating an American Empire reminiscent of resembling those in Europe. However, Walker's plans were cut short due to a coordinated Central American

[54] Ropp and Morris, *Central America: Crisis and Adaptation*, 14.
[55] Ropp and Morris, 14–15.
[56] Ropp and Morris, 14–15.

response to the Walker invasion. Walker was deposed from power the same year he assumed power, and was executed by a Honduran firing squad in 1860.[57] It must be noted that the United States government was heavily opposed to the invasion of Nicaragua by Walker. In an 1858 letter to the United States Senate, President James Buchanan wrote that the invasion "violates the principles of Christianity, morality, and humanity, held sacred by all civilized nations and by none more than by the people of the United States. Disguise it as we may, such a military expedition is an invitation to reckless and lawless men to enlist under the banner of an adventurer to rob, plunder, and murder the unoffending citizens of neighboring states, who have never done them harm" [58] With the expulsion of American invaders from the region an end of political violence began, paving the way for autonomous economic and political development in the latter parts of the 19th century.

Aside from the waning desires to form a federation and the expulsion of American filibusters, surprisingly, coffee played a pivotal role in the end of political violence in Central America. Coffee was originally introduced to Costa Rica in the 1830s and spread to El Salvador by the 1860s.[59] The spread of coffee production throughout the region allowed regional elites to agree on the value of political stability as it allowed for their profits to grow without fear of conflict. As a result, coffee revenues served "as an economic base for such elite consensus." [60] However, regional differences in the introduction of coffee quickly arose. While massive coffee fortunes were being built in Costa Rica and El Salvador, continued elite infighting in Honduras and Nicaragua prevented both countries from taking part in the early economic benefits of

[57] Haar, "The Nicaragua Canal Story," 190.
[58] James Buchanan, "Message to the Senate on the Arrest of William Walker in Nicaragua," January 7, 1858, https://www.presidency.ucsb.edu/documents/message-the-senate-the-arrest-william-walker-nicaragua.
[59] Ropp and Morris, *Central America: Crisis and Adaptation*, 15.
[60] Ropp and Morris, 15.

commercial coffee production.[61]

After independence from the Federal Republic of Central America, several Conservative governments were established in various of the newly created nations. For most of the mid-1800s, Conservative governments ruled Central America. The Conservatives advocated for a greater role for the Catholic Church within the politics of their respective countries, greater consolidation of power, as well as inclusion into world markets.[62] One of the primary efforts of Conservative governments after the dissolvement of the federation was to get rid of Liberal reforms introduced in the latter period of the Federal Republic. Specifically, in Guatemala, the former capital of the federation, the government restored the colonial land institutions of the Spanish Empire. The Conservative government's policies effectively helped concentrate the country's wealth to a relatively few wealthy landowners, which heavily prevented the country from achieving a dynamic economy.[63] With Conservative regimes came a "strengthening of clerical power, restoration of regular orders and Hispanic institutions, and consolidation of political and social power by the aristocratic landholders." [64] Even with a return to colonial structures, it must be noted that under Conservative governments, greater economic growth had been achieved than under Liberal rule during the early years of independence in the former Federal Republic. All states, with the exception of El Salvador, expanded their export markets significantly, helping each country establish favorable trade balances and leading to an improvement to their respective debt levels.[65] However, during the 1870s, several Conservative governments were voted out of office as traditional values and institutions were rejected by the

[61] Ropp and Morris, 15.
[62] Woodward, *Central America: A Nation Divided*, 113.
[63] Woodward, 114.
[64] Woodward, 116.
[65] Woodward, 117.

population and attacks against the Catholic Church became common. Specifically, Conservative governments were replaced with Liberal administrations in Guatemala, El Salvador, Honduras, and Costa Rica.[66]

The Liberal reforms of the late nineteenth century were a pivotal turning point for Central America. The reforms aided the region to become more integrated into the global economy, breaking away from its long history of isolation. A considerable growth in agricultural markets, as well as the acquisition of foreign capital and technology aided the region in its pursuit of economic development. Infrastructure investments were also common in the region at the time, facilitated by international capital and foreign investors. Nonetheless, while Central America did experience economic growth during the Liberal years, the economy did not fundamentally change. Agricultural exports continued to be the primary components of the region's economic activity, subject to the market forces of international supply and demand and fluctuating commodity prices.[67]

In Costa Rica, the rise of Liberal Dr. Jose Maria Montealegre to the Presidency marked a notable shift in the country's government. Montealegre introduced a series of reforms centered on the democratization of the political system of Costa Rica. Specifically, through the introduction of education and economic reforms, Montealegre was able to create a Liberal foundation for the nation's government, helping Liberals stay in power for a considerable period of time.[68] While some key reforms were introduced during the Liberal years in the late 19th century, it is crucial to mention that the political and economic systems of Central America did not fundamentally change. While there were variations between Conservative and Liberal

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[66] Ropp and Morris, *Central America: Crisis and Adaptation*, 16.
[67] Ropp and Morris, 17–18.
[68] Woodward, *Central America: A Nation Divided*, 154.

caudillos, caudillos still governed the region with an iron fist and with the support of the armed forces, leaving little room for dissent and opposition. Furthermore, while some wealth was redistributed, the region's wealth was still held by a select few who aligned themselves with the caudillo in power. However, while wealth was still heavily concentrated at the hands of wealthy landowners, the Liberal Reforms were heavily responsible for the creation of the region's middle class, which paved the way for a more efficient economy.[69] With a greater role in their respective country's economy, the newly created, albeit small, Central American middle class allowed for greater integration of the region into the world economy, especially through agricultural products and commodities. Thus, the late nineteenth century was crucial in the integration of Central America into the world economy, primarily into agricultural markets where Central American nations could export their coffee and indigo, the two main crop exports from the region at the time.

Central America in Modernity: Twentieth Century and Beyond

In the twentieth century, Central America has been more active in the world stage, often receiving international attention for its internal affairs. The Nicaraguan Civil War and the subsequent Iran-Contra Affair, the Salvadorian and Guatemalan Civil Wars are some of the few events that have captured international attention and led to policy decisions by Western governments, primarily from the United States.[70] [71] [72] Furthermore, the early twentieth century was central to the latter developments explored in this thesis, especially surrounding the

[69] Woodward, 155.
[70] Ronald Reagan, "Address to the Nation on the Situation in Nicaragua" (Washington, D.C, March 16, 1986), https://www.reaganlibrary.gov/archives/speech/address-nation-situation-nicaragua.
[71] Raymond Bonner, "The Agony of El Salvador," *New York Times*, February 22, 1981, https://www.nytimes.com/1981/02/22/magazine/the-agony-of-el-salvador.html.
[72] Will Grant, "Was There Genocide in Guatemala?," *BBC News*, May 24, 2013, https://www.bbc.com/news/world-latin-america-22649355.

development of political and economic institutions. Specifically, the establishment of dictatorships in certain Central American nations hindered the creation of meaningful economic growth and economic diversification.

The early years of the 20th century were marked by Panama's independence from Colombia and the subsequent construction of the Panama Canal. It is important to recognize the massive role the United States, under the Theodore Roosevelt administration, played in Panama's independence and in the construction and administration of the Canal Zone. In 1903, Panama declared independence from Colombia with support from the United States. Through the ratification of the 1903 Hay-Bunau-Varilla Treaty between Panama and the United States, the newly independent Republic of Panama granted the United States the right to use, occupy, and control the Canal Zone in perpetuity in exchange of securing Panamanian independence from Colombia.[73] The United States' interest in the construction of the Panama Canal stemmed from a long standing desire to construct an interoceanic canal in Central America, ranging as far back as the early 19th century.[74] The negotiated treaty between both nations was with the intention of securing political stability in the Isthmus, which was imperative for the construction of the Canal, for which the United States would reap significant economic benefits from for decades to come.[75] With the beginning of American control over the Canal Zone, the United States' foreign policy toward Latin America began to experience a shift. Rather than continuing with the passive approach of the Monroe Doctrine, the United States, with the addition of the Roosevelt Corollary, assumed the role of regional policeman. Under its new self-imposed responsibilities,

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[73] Daniel J. Flood, "Panama Canal Zone: Constitutional Domain of the United States," *World Affairs* 121, no. 3 (Fall 1958): 74.
[74] Noel Maurer and Carlos Yu, "What T.R. Took: The Economic Impact of the Panama Canal, 1903-1937," *The Journal of Economic History* 68, no. 3 (September 2008): 687.
[75] Flood, "Panama Canal Zone: Constitutional Domain of the United States," 75.

the United States sought a policy where it could intervene in another nation's affairs as a method of last resort to ensure regional stability. In practice, an increase in military force was experienced in the early decades of the 20th century, creating an early justification for American interventionism throughout the region.[76] Criticisms from Latin American leaders soon began to occur. Colombia, due to Panamanian independence, was outraged at the United States' involvement in the independence of Panama and its control over the Canal Zone. Other nations believed that the addition of the Roosevelt Corollary to the Monroe Doctrine converted foreign policy in Latin America from a protective policy to a policy of "selfish aggression." [77] Thus, the early 20th century was pivotal in American foreign relations with its Central American neighbors, as the former protector of the relatively weak region assumed a more active role in the region's internal affairs.

In the 1930s, dictatorships were common in the region, backed by elites and supported by the armed forces, as well as receiving outside support from the United States. Maximiliano Hernandez Martinez in El Salvador (1931-1944), Tiburcio Carias Andino in Honduras (1932-1949), Jorge Ubico in Guatemala (1931-1944), and Anastasio Somoza Garcia in Nicaragua (1932-1956) were the dictators that ruled the region for a considerable portion of the 20th century.[78] Often, these dictators managed to remain in power with the help of the United States, which sought to protect its economic interests in the region by creating alliances with military-backed dictators. The United States openly supported three generations of Somoza dictators in Nicaragua from 1936 to 1979, as well as providing support for Jorge Ubico of Guatemala from

[76] Office of the Historian, "Roosevelt Corollary to the Monroe Doctrine, 1904," United States Department of State, *Milestones in the History of U.S. Foreign Relations* (blog), n.d., https://history.state.gov/milestones/1899-1913/roosevelt-and-monroe-doctrine.
[77] John Holladay Latané, "The Effect of the Panama Canal on Our Relations with Latin America," *The Annals of the American Academy of Political and Social Science* 54 (July 1914): 87–88.
[78] Ropp and Morris, *Central America: Crisis and Adaptation*, 20.

1931 to 1944.[79] [80] It is of importance to note that, as is the norm in most dictator-led nations, the Central American dictators funneled public funds into their private estates, enriching their families while most of the population lived under substandard levels.[81] Considering that Central America yet remained an agricultural society with no to little economic diversification, dictators who stole public funds set the region behind economically, as the funds were not invested in areas of potential economic growth. Although some economic diversification did occur in the region, agricultural exports, primarily coffee and bananas, continued to be the main source of all Central American nations' income. The region's issues with economic diversification continued to persist well into the latter part of the 20th century. Specifically, between 1970 and 1980, "thirteen primary products accounted for nearly two-thirds of all regional exports by value." [82] As seen, Central America, for most of its history, has remained a particularly agricultural society with limited economic diversification that has prevented it from achieving significant economic growth. For a region that is subject to the movements of international markets and foreign economic policy, it is of utmost importance to achieve some form of economic diversification. Economic diversification, if achieved, leads to an increase in the productivity of labor, and an overall increase of revenue ad capital, helping a nation's economic prospects.[83] Most importantly however, economic diversification provides nations a shield of protection from volatile international markets and prices.

It is of utmost importance to recognize that the lack of economic growth in the region can be traced back to the global events of the 1980s, particularly the Lost Decade. The Lost Decade

[79] Shirley Christian, "Nicaragua and the United States," *World Affairs* 149, no. 4 (1987): 177.
[80] Kenneth J. Grieb, "American Involvement in the Rise of Jorge Ubico," *Caribbean Studies* 10, no. 1 (1970): 5.
[81] Richard Sholk, "The National Bourgeoisie in Post-Revolutionary Nicaragua," *Comparative Politics* 16, no. 3 (1984): 254.
[82] Ropp and Morris, *Central America: Crisis and Adaptation*, 21.
[83] Alexander Hamilton, *Report on Manufactures* (Boston, MA: Potter Publishing Company, 1791), 23.

was a period of vast economic crises throughout all Latin America, reaching every corner of the region. Central America experienced large external imbalances, high inflation, output stagnation, and a deterioration of social conditions. Aside from vast economic problems, the region likewise suffered sociopolitical instability, as armed conflicts raged through El Salvador, Guatemala, and Nicaragua, which had indirect effects on the economies of Costa Rica and Honduras.[84] However, while Central America did undergo serious economic problems throughout the 1980s, that is not to mean that it did not face problems in the 1990s. Rather, economic problems persisted throughout the region well into the next decade. For example, Honduras continued its weak performance well into the 1990s, mostly due to low factor productivity and the devastating effects of Hurricane Mitch on the economy in 1998, where the damages constituted 79.8% of that year's GDP.[85] [86]

Due to the devastating economic and social ramifications of the Lost Decade, Central American countries enacted a series of structural and institutional reforms in the 1990s, which eventually came to be known as Washington Consensus policies. It must be noted that these reforms were not solely designed for Central America, but rather for Latin America more generally. It must also be noted that the United States, the World Bank and the International Monetary Fund would only provide funding for projects or structural reforms to nations if and only if they committed to enact Washington Consensus policies. Central American nations, cash-strapped and underdeveloped, for the most part, enacted the Washington Consensus policies, yet their populations continued to reside in substandard living conditions and did not see a

[84] Leonardo Cardemil, Juan Carlos Di Tata, and Florencia Frantischek, "Central America: Adjustment and Reforms in the 1990s," *Finance & Development* 37, no. 1 (March 2000): 34.
[85] Cardemil, Di Tata, and Frantischek, 35.
[86] Hugo E. Beteta and Juan Carlos Moreno-Brid, *Structural Change and Growth in Central America and the Dominican Republic: An Overview of Two Decades, 1990-2011* (Santiago, Chile: Economic Commission for Latin America and the Caribbean (ECLAC), 2014), 253.

meaningful change to their economic prospects.[87] By the late 1990s, virtually every country in Latin America had adopted the neoliberal, free trade, 'market-friendly' policies sponsored the Washington Consensus.[88] The effects of the Washington Consensus policies can be seen throughout the 1990s, just a few years after being implemented. At first, the policies provided some short-term economic growth for Latin American economies, but ultimately these nations continue to be riddled with deep structural economic issues.[89]

While these policies did work in some countries, as in Costa Rica, they did not bring meaningful change to the economies of other nations, such as Mexico and Honduras. For example, Mexico suffered economically through the 1980s and likewise experienced multiple economic crises throughout the 1990s. Specifically, the Mexican economic crisis of the 1990s arose from the mismanagement of the Mexican peso and its exchange rate. As a response to the crisis, the United States, under the coordination of the International Monetary Fund, gave Mexico a $50 billion loan to help stabilize the currency.[90] In exchange for the loan, the IMF demanded Mexico to implement Washington Consensus reforms. Such reforms did not immediately help the country overcome its economic crisis, instead it brought a series of new economic problems, such as rising incidences of poverty, falling or stagnating wages, and rapid increases of income inequality, to the forefront of Mexican society.

Why the policies were able to succeed in some countries and not in others can be explained by one of the primary criticisms of the Washington Consensus. Rodrik (2003) argued that the Washington Consensus was bound to disappoint because any list of policy reforms offers

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[87] James M. Cypher, "The Slow Death of the Washington Consensus on Latin America," *Latin American Perspectives* 25, no. 6 (November 1998): 47.
[88] Cypher, 47.
[89] Jane D'Arista, "Moving Beyond the Washington Consensus," *International Journal of Political Economy* 32, no. 4 (Winter /2003 2002): 26.
[90] Cypher, "The Slow Death of the Washington Consensus on Latin America," 48.

an agenda that is insensitive to local context and need.[91] Rodrik referred to the Washington Consensus the "ten commandments," which makes it seem as if the Washington Consensus expected miracles to occur within each country where its policies were implemented.[92] Ultimately, it seems that while Latin American countries' experiences with Washington Consensus policies have varied, the region has overall been harmed more than it has been helped. After all, prescribing a one-size-fits-all solution, like Rodrik previously noted, is bound to disappoint, and possibly bring more economic issues, as was the case in Mexico.

Aside from facing persistent economic problems, the region likewise has long struggled with its political structures. Central American nations have historically struggled in their democratic pursuits. With the notable exception of Costa Rica, Central American political systems were authoritarian well into the 1980s and 1990s, when democratic transitions in Nicaragua, El Salvador, Honduras, and Guatemala allowed a rebirth of democracy in the region to occur.[93] However, even with the rebirth of democracy and new hopes of a change in the system, Central America has not fared better in international markets, as it continues to struggle to develop economically due to its lack of economic diversification. However, that does not mean that the entire region has struggled economically. Rather, some Central nations, particularly Costa Rica and Panama, have achieved levels of economic development unheard of in other Central American nations. Specifically, by 2006, Costa Rica and Panama had achieved GDP per capita rates 50 percent larger than in 1980, yet Guatemala and Honduras had the same GDP per capita in 2006 than in 1980. El Salvador's GDP per capita rate slightly increased, while

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[91] Dani Rodrik, "Growth Strategies," NBER Working Paper Series (National Bureau of Economic Research, October 2003), 23, https://www.nber.org/system/files/working_papers/w10050/w10050.pdf.
[92] Williamson, "The Strange History of the Washington Consensus," 205.
[93] Fabrice Lehoucq, *The Politics of Modern Central America: Civil War, Democratization, and Underdevelopment* (Cambridge, UK and New York, NY: Cambridge University Press, 2012), 3.

Nicaragua's GDP per capita had declined almost by a fourth since 1980.[94] Clearly, the lack of economic development has not only separated the region from the developed world but has created regional divergences as well. In 1980, the richest Central American nations had GDP per capita rates twice as large as their poorest neighbors, yet in 2006 this ratio was three or four times as large.[95] The economic divergence that has occurred in the region is of utmost importance to this thesis, specifically comparing Costa Rica and Honduras' economic development paths.

Costa Rica's role as one of the most developed nations in the region deserves brief discussion. Central American historians and sociologists have long argued that the way in which Costa Rican society was set up has clearly influenced its democratic nature relative to the rest of Central America. Specifically, "a more egalitarian distribution of resources in the country" has allowed democracy to flourish in Costa Rica and be absent elsewhere.[96] Going back to the 19th century, a scarcity of labor in Costa Rica forced landlords to pay laborers decent wages to harvest coffee, as well as encouraged one's own agricultural pursuits in the country's frontier. Since then, compromise has been reached through a series of bargains between the upper and lower classes in Costa Rica, which has not been the case in the rest of the Central American nations.[97] Elsewhere, the state apparatus militarized to promote the interests of large commercial agriculture, leading to the rise of autocracy throughout the region.[98] These early developments in the 19th century were crucial to the development of democracy in Costa Rica, as it created an institutional incentive for bargaining between social classes, a key aspect absent from other

[94] Lehoucq, 4.
[95] Lehoucq, 4.
[96] Lehoucq, 19.
[97] Lehoucq, 19.
[98] Lehoucq, 19.

Central American states.

The United States continues to play an important role in the region's economy and politics. Today, the United States continues to be the region's biggest trading partner, accounting since the early 1980s for around 40% of total merchandise exports from the region.[99] Due to its vast economic power, the United States continues to be a heavy influence in Central American politics and economics, especially in the modern democracies. For example, the United States has a military presence in Honduras at the Soto Cano Air Base.[100] The United States likewise continues to provide vast amounts of development aid money to Central American nations, whether they be for specific projects or structural reforms, in hopes of deterring future waves of immigrants.[101] It is clear that the United States has played a crucial role in the development history of Central America, as it has, for most of its history, been directly interested in its regional economic interests and expanding its sphere of influence. Yet, if Central America has attracted such attention from the world's hegemon for the past 200 years, why has it not able to develop properly given all the "correct" resources?

In 2022, most nations in Central America are democratic. Yet, there have been some growing worries about how sustainable democracy's gains will be in the region. For example, there were major concerns that the incumbent political party of Honduras would steal the 2021 Presidential Election.[102] Soon after the incumbent party's defeat at the polls, it was announced that former Honduran President Juan Orlando Hernandez was to be extradited to the United

[99] Shaun K. Roache, "Central America's Regional Trends and U.S. Cycles," *IMF ELibrary*, 2008, 2.
[100] Todd South, "Deep in the Mountains of Honduras, Few Know What This US Military Task Force Does," *Army Times*, August 12, 2019, https://www.armytimes.com/news/your-army/2019/08/12/deep-in-the-mountains-of-honduras-few-know-what-this-us-military-task-force-does/.
[101] Nicole Narea, "Sending Aid to Central America Won't Stop Migrants from Coming," *Vox*, April 30, 2021, https://www.vox.com/policy-and-politics/22404000/foreign-aid-biden-central-america-migration-root-causes.
[102] Gustavo Palencia and David Alire Garcia, "In Honduras, Parties Flag Fears of Fraud Ahead of Pivotal Vote," *Reuters*, November 27, 2021, https://www.reuters.com/world/americas/honduras-parties-flag-fears-fraud-ahead-pivotal-vote-2021-11-27/.

States to face narcotrafficking charges.[103] In El Salvador, President Nayib Bukele has in multiple instances worried international human rights organizations and democracy advocates as he advocates for a tough on crime approach to the country's gang problems.[104] In Nicaragua, democracy has been on decline since President Daniel Ortega changed the country's Constitution to remain in power indefinitely, as well as appointing his wife, Rosario Murillo, to serve as Vice President.[105] [106] With democracy in retreat in region, Costa Rica once again has been able to distinguish itself from the rest, boasting rather boring and customary elections.[107]

Central America faces various challenges in the 21st century. It faces a retreat of democracy and a rise of autocratic presidents. Combined with stagnant economic growth and substandard economic conditions for most, it is only a matter of time before Central America once again descends into the dangerous times of the mid-20th century, where it suffered from popular uprisings and civil warfare. Yet, Costa Rica continues to provide a shining example of democracy and economic growth, breaking out of the expectations Westerners often place on the region. The question then becomes: If most of the region seems to follow a pattern of economic stagnation and autocracy, then how has Costa Rica been able to break such pattern? What exactly has been the role of political institutions in shaping Costa Rica's economic growth prospects relative to Honduras, which has remained stagnant for most of its recent history?

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[103] Santiago Perez and Juan Carlos Rivera, "Former Honduras President to Be Extradited to the U.S. on Drug-Trafficking Charges," *The Wall Street Journal*, March 28, 2022, https://www.wsj.com/articles/former-honduras-president-to-be-extradited-to-the-u-s-on-drug-trafficking-charges-11648498461.
[104] Felipe De La Hoz, "El Salvador's Leader Is Updating the Autocrat Playbook for the TikTok Generation," *The Washington Post*, May 25, 2021, https://www.washingtonpost.com/outlook/2021/05/25/bukele-autocrat-playbook-tiktok/.
[105] Carlos F. Chamorro, "In Nicaragua, a Blatantly Rigged Election," *The New York Times*, November 4, 2016, https://www.nytimes.com/2016/11/05/opinion/in-nicaragua-a-blatantly-rigged-election.html?searchResultPosition=13.
[106] Tracy Wilkinson, "Nicaragua's First Lady Is a Powerful Partner of President," *Los Angeles Times*, May 24, 2015, https://www.latimes.com/world/mexico-americas/la-fg-nicaragua-trees-20150524-story.html.
[107] Javier Cordoba, "With 25 Candidates, Costa Rica's Election up for Grabs," *ABC News*, February 3, 2022, https://abcnews.go.com/International/wireStory/25-candidates-costa-ricas-election-grabs-82648598.

The Lost Decade, The Washington Consensus, and 1990s Economic Divergence

The Lost Decade

The Lost Decade was a period of vast economic crises throughout 1980s Latin America. Central America, due to its interconnectedness with other Latin American nations, was not an exception to the events that transpired throughout the region. The Central American nations experienced large external imbalances, high inflation, output stagnation, and a deterioration of social conditions. While the Lost Decade officially started with the Mexican economic crisis of 1982, Central America had begun to show multiple signs of economic decay toward the end of the 1970s, signaling that while the region was affected by the Mexican crisis, it did not cause the economic problems of the region.

In the late 1970s, Latin America was undergoing an impressive economic boom that reassured international investors and the developed world of the region's economic prospects. The Mexican economic boom, for example, was being driven by new oil discoveries, high prices for the newfound oil, and large loans from multinational banks. As a result of such boom, few saw the possibility of an economic slowdown and much less the possibility of a debt default in Mexico.[108] In Honduras, the 1970s proved to be a period of sustained economic growth with stable prices and stable foreign exchange rates, leading to important social achievements, primarily increased healthcare access for the population and a sustained decrease in mortality rates.[109] Furthermore, an increase in exports and public expenditures led Honduras to achieve its best economic performance since World War II, averaging an average annual real GDP growth

[108] Paul Krugman, "Warning Ignored: Latin America's Crises," in *The Return of Depression Economics and The Crisis of 2008* (New York, NY: W. W.Norton & Company, 2009), 33.
[109] Guillermo Molina Chocano, "Honduras: Crisis Económica, Elecciones y Sistema Político (1980-1990)," *Revista Mexicana de Sociología* 52, no. 4 (1990): 303.

rate of 8.8 percent from 1976 to 1979.[110] While Mexico and Honduras achieved significant economic growth in the late 1970s, other countries in the Central American region started to show significant economic challenges. Specifically, Costa Rica ended the 1970s with profound economic issues that would plague its economy well through the 1980s. In the late 1970s, Costa Rica was subject to price fluctuations in the international markets for its two major exports, coffee and bananas, making its economy highly susceptible to an economic crisis.[111] As seen, the late 1970s were experienced differently by these three Latin American countries, thus it is unfair to say that the Mexican economic crisis of 1982, which kicks off the Lost Decade, was a primary cause of the Central American economic crises, as some Central American economies were already experiencing major economic issues at the turn of the decade. Rather, it is important to note that Costa Rica and Honduras entered the 1980s with several economic problems unrelated to the Mexican crisis, exposing deep structural problems within their respective economies, primarily their dependence on international import and export markets and issues with international financing.

The 1980s proved to be a pivotal decade for Central America, as the economic crises of the decade were highly responsible for economic policy shifts advocated by the United States and multilateral financial organizations, primarily the World Bank and the International Monetary Fund. Prior to getting into a discussion of the U.S.-backed reforms, it is important to provide an account of the various economic crises experienced by Honduras and Costa Rica at the end of the 1970s and through the 1980s. Ending the 1970s, Honduras was experiencing rapid

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[110] Hugo Rolando Noé Pino, "The Structural Roots of Crisis: Economic Growth and Decline in Honduras, 1950-1984" (Austin, TX, The University of Texas at Austin, 1988), 156–61, https://www.proquest.com/docview/303734017/fulltextPDF/8D8D12E7E6CC4683PQ/1?accountid=9681&parentSessionId=tZg2xhNFLvXKxMevLkdLilofU3cImDgFByh9lYJr%2FmI%3D.
[111] Ropp and Morris, *Central America: Crisis and Adaptation*, 177.

economic growth, led by military leaders who deemed social peace and political order an integral component of Honduran society and its economy. With the installment of Colonel Policarpo Paz García as the Honduran head of state in 1978, the military regime became less reformist and more developmentalist, seeking to attract international public and private capital to finance state-led development programs. As a result of these policy changes, the state assumed a more aggressive role in its national economic development.[112] Due to the state's increased involvement in the economy, Honduras achieved impressive economic growth from 1976 to 1980, averaging an annual average real GDP growth rate of 8.8 percent.[113] The impressive economic growth of the late 1970s was driven by an overall increase in exports and an increase in public expenditures, leading the decade to end in a positive economic balance.[114] While the end of the 1970s proved to be a period of impressive economic growth for Honduras, the economic growth was brought to a halt in 1980. A major decrease in the real rate of GDP growth became evident, as the Honduran economy grew at only 0.6 percent in 1980, down from its average of 8.8 percent during the four previous years. The Honduran economy was not able to recover for various years, only able to grow at an annual average rate of only 0.7 percent from 1980 to 1984.[115]

While it is clear that Honduras was experiencing an economic crisis in the early 1980s from its real rate of GDP growth data, it is imperative to note that there were other major economic problems occurring within the country at the same time. Per capita GDP dropped from U.S. $628 in 1979 to U.S. $565 in 1984, signaling a significant decrease in the consumer's income and purchasing power.[116] Major problems were also present in the country's import and

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[112] Ropp and Morris, 201.
[113] Noé Pino, "The Structural Roots of Crisis: Economic Growth and Decline in Honduras, 1950-1984," 160.
[114] Noé Pino, 156.
[115] Noé Pino, 160.
[116] Noé Pino, 161.

export markets, with exports dropping from an average annual growth rate of almost 10 percent from 1976 to 1980 to a negative 0.3 percent average annual growth rate from 1980 to 1984. Imports decreased from an average annual growth rate of 12 percent at the end of the 1970s to a negative 0.2 percent average annual growth rate from 1980 to 1984.[117] Inflation also saw a return to the region, with Honduras experiencing double digit inflation for the first time since World War II, seeing 12.1 percent in 1979 and 18.1 percent in 1980. However, inflation began to decrease in the following years. The unemployment rate rose from 8.8 percent in 1980 to 10.7 percent in 1984.[118] It must be noted that Honduran economic data, especially unemployment data, has been subject to scrutiny, especially as multiple organizations have reached vastly different conclusions regarding unemployment. For example, the Colegio Hondureño de Economistas estimated Honduran unemployment to be 45 percent in 1983,[119] vastly different from the United Nations Economic Commission for Latin America (CEPAL) and Honduran Central Bank estimate of 10.7 percent unemployment in 1984.

Costa Rica entered the 1980s with several economic problems. Subject to international export market price fluctuations, Costa Rica saw plummeting export revenues with decreasing coffee and banana prices. Furthermore, the increasing price of oil deeply impacted the trade balance. As a result, the government borrowed heavily from foreign banks to finance imports. Subsequently, high interest rates and capital flight, caused by regional turmoil, caused dollar reserves to run out in 1980.[120] The absence of dollar reserves, decreased export revenues and increased import expenditures led to a massive devaluation of the currency, the *colón*, which fell

[117] Noé Pino, 161.
[118] Noé Pino, 162–63.
[119] Noé Pino, 163.
[120] Ropp and Morris, *Central America: Crisis and Adaptation*, 177.

from 9:1 to 60:1 to the dollar.[121] As a result of the devaluation of the *colón,* Costa Rica defaulted on debt interest payments in 1981.[122] In addition to the default, the private sector was unable to import raw materials and replacement parts, leading to a severe recession, massive layoffs and increasing unemployment.[123] Furthermore, the devaluation of the *colón* led to inflation soaring to about 150 percent up until 1982.[124] The 1981 default, alongside the severe recession, required the International Monetary Fund to intervene to help resolve the crisis. President Rodrigo Carazo, who ruled Costa Rica from 1978 to 1982, originally rejected the IMF proposals, calling the terms of the agreement draconian. Ultimately, with the 1982 election of President Luis Monge, the Costa Rican government accepted the IMF's conditions, the $2.5 billion debt was rescheduled, and economic policies were introduced to ensure debt repayment.[125] As a result of the IMF intervention, the *colón* recovered some strength and stabilized at 43:1 to the dollar.[126] The IMF intervention helped Costa Rica avoid an outright economic collapse, however they did not provide long-term solutions to the deep structural issues in the Costa Rican economy.

In 1983, Costa Rica's economy was provided short-term relief with an increase in the price of coffee and bananas in the international markets, aiding the country's balance of payments and trade balance.[127] However, as seen, the Costa Rican economy's high dependence on international export markets continued to pose a major challenge for Costa Rican leaders through the mid-1980s. Some progress was made in the 1980s with economic diversification in the agricultural sphere, with increased production of citrus fruits, macadamia nuts, and

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[121] Ropp and Morris, 177.
[122] Marjorie Miller, "Big Costa Rica Debt Too Small to Sway Creditors," *Los Angeles Times*, May 25, 1986, https://www.latimes.com/archives/la-xpm-1986-05-25-mn-7263-story.html.
[123] Ropp and Morris, *Central America: Crisis and Adaptation*, 177.
[124] Ropp and Morris, 178.
[125] Ropp and Morris, 177.
[126] Ropp and Morris, 177.
[127] Ropp and Morris, 178.

flowers.[128] However, Costa Rica's continued dependence on international markets proved too great even with the introduction of IMF reforms in 1982. Eventually, economic issues once again came to plague the Costa Rican economy, starting in 1983 and continuing through 1990. Between 1983 and 1988, real wages dropped 42 percent, though employment rates remained higher in Costa Rica relative to the rest of Central America. After 1983, once again Costa Rica started to experience a growing trade deficit. As a result of these consistent economic issues, under the leadership of President Oscar Arias, who ruled Costa Rica from 1986 to 1990 and from 2006 to 2010, Costa Rica began to pursue neoliberal reforms.

In 1987, President Oscar Arias and the Partido Liberación Nacional (PLN) began to dismantle the welfare state and reduced public spending significantly. The government likewise engaged in the privatization of state-owned enterprises, primarily banks, such as the Banco de Costa Rica and the Banco Internacional de Costa Rica, and other state agencies, such as Costa Rican Corporation for Development (CODESA), the state-owned cement producer (CEMPASA), and the state-owned fertilizer producer (FERTICA).[129] [130] With the introduction of newly private financial institutions, small and medium sized farmers became effectively shut out of sources of credit, hindering their ability to participate in the Costa Rican economy and causing civil discontent with the Arias administration.[131] In 1990, the Costa Rican government, due to the austerity measures introduced, was able to buy back its debt at substantial discounts,[132] however not without consequences. Real wages continued to decline, causing labor problems. Labor

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[128] Woodward, *Central America: A Nation Divided*, 231.

[129] Ileana Muñoz and Claudio Antonio Vargas, "La Producción de Fertilizantes En Costa Rica y El Modelo Estatal Costarricense: El Caso FERTICA," *Anuario de Estudios Centroamericanos* 18, no. 1 (1992): 61.

[130] Juan Manuel Villasuso, "Reformas Estructurales y Política Económica En Costa Rica," Serie Reformas Económicas (United Nations Economic Comission for Latin America and the Caribbean (CEPAL), 2000), 28–30, https://www.cepal.org/sites/default/files/publication/files/7608/S2000578_es.pdf.

[131] Woodward, *Central America: A Nation Divided*, 231.

[132] Jeremy Bulow and Kenneth Rogoff, "Sovereign Debt Repurchases: No Cure for Overhang," *The Quarterly Journal of Economics* 106, no. 4 (1991): 1220.

strikes occurred throughout the nation, both in urban and rural areas, to protest the declining living standards and the austerity measures introduced by the Arias government. In 1990, more than 70,000 workers, who worked in public institutions like the healthcare system, participated in a labor strike protesting the rising costs of living and the austerity measures.[133] The austerity measures were so unpopular among the Costa Rican population that the PLN, the incumbent political party, was defeated in the 1990 presidential election, which brought Rafael Calderón of the Partido Unidad Social Cristiana (PUSC) to power, who promised popular policies like food self-sufficiency and economic reforms.[134]

As seen, the 1980s were a period of severe economic crises in Central America. Deep structural issues in the economy plagued the administrations in power for most of the 1980s, ultimately leading to political defeat and stagnant growth. However, it is to be noted that while persistent structural issues in the economy did contribute significantly to the economic downturns of the 1980s, they were not the sole reason for the economic decay. Rather, Costa Rica and Honduras found themselves in a rather delicate international context where small open economies were deeply subjected to the economic misgivings of the developed world. Thus, an ample consensus has developed in the Central American literature regarding the economic crises of the 1980s. Specifically, "an increase in the price of oil in 1979, inflation and recession in the developed countries, and high interest rates due to the deflationary policies in those countries contributed to the inflation process, the fall in exports, the increase in the value of imports, the worsened terms of trade, the increase in the service of the external debt, the loss of international reserves, and finally, a period of recession in these small economies." [135] The economic decay of

[133] "Strike in Costa Rica," *New York Times*, October 6, 1990, https://www.nytimes.com/1990/10/06/business/strike-in-costa-rica.html.
[134] Woodward, *Central America: A Nation Divided*, 232.
[135] Noé Pino, "The Structural Roots of Crisis: Economic Growth and Decline in Honduras, 1950-1984," 165–66.

the 1980s set back the region and its development prospects. Regional instability due to civil war and civil unrest, lack of investor trust as a result of such turmoil, and a fragile international context prevented Costa Rica and Honduras from achieving significant economic growth in the 1980s.

Aside from vast economic problems, the region likewise suffered sociopolitical instability, as armed conflicts raged through El Salvador, Guatemala, and Nicaragua, which had indirect effects on the economies of Costa Rica and Honduras.[136] Primarily, the massive influx of refugees fleeing civil conflict in the region deeply impacted the Honduran and Costa Rican economies, as they were the only safe havens in Central America during the 1980s. In the 1980s, Costa Rica's population was growing at near 2.5 percent per year, however, due to the Nicaraguan Civil War, approximately 400,000 Nicaraguans migrated into Costa Rica throughout the decade.[137] A similar story occurred in Honduras. Approximately 35,000 Salvadoran refugees fled into Honduras in 1980 and 1981 with the offset of the Salvadoran Civil War. Many Nicaraguans likewise fled into Honduras, escaping civil conflict.[138] While Costa Rica and Honduras accepted the refugees fleeing civil conflict, it did so with massive effects to their economies. First, Costa Rica and Honduras were already experiencing economic issues at the beginning of the 1980s, and with the addition of thousands, if not hundreds of thousands, refugees, their economies were deeply strained and under pressure. The Costa Rican and Honduran states, and their economies, were simply unprepared to effectively deal with the influx of refugees from neighboring states. As a result of stagnant growth and rapidly growing

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[136] Cardemil, Di Tata, and Frantischek, "Central America: Adjustment and Reforms in the 1990s," 34.
[137] Woodward, *Central America: A Nation Divided,* 232.
[138] Steve Cagan, "Salvadoran Refugees in the Camp at Colomoncagua, Honduras, 1980-1991," *ReVista Harvard Review of Latin America* 15, no. 3 (2016), https://revista.drclas.harvard.edu/salvadoran-refugees-in-the-camp-at-colomoncagua-honduras-1980-1991/.

populations, per capita economic indicators rapidly declined, further escalating the already ongoing economic crises.

Due to the devastating economic and social ramifications of the Lost Decade, Central American countries enacted a series of structural and institutional reforms in the 1990s, which eventually came to be known as Washington Consensus policies. It must be noted that these reforms were not solely designed for Central America, but rather for Latin America more generally. By the late 1990s, virtually every country in Latin America had adopted the neoliberal, free trade, 'market-friendly' policies of the Washington Consensus.[139] The effects of the Washington Consensus policies can be seen in the 1990s, just a few years after being implemented. At first, the policies provided some short-term economic growth for Latin American economies, but ultimately these nations continue to be riddled with economic issues.[140]

The Washington Consensus: Policies and Effects

To address the various economic crises of the 1980s, virtually all Latin American countries implemented a series of economic reforms which would later be coined The Washington Consensus. Washington Consensus policies consisted of ten policy actions designed to bring an economic revival to the region. The ten policy actions were: small budget deficits, a shift of public resources toward areas with high economic returns, tax reforms, financial liberalization obtained through market determined interest rates, a unified exchange rate, a shift from quantitative trade restrictions toward low tariffs, abolition of barriers to entry for foreign direct investment, privatization of state-owned enterprises, abolition of barriers to entry for new

[139] Cypher, "The Slow Death of the Washington Consensus on Latin America," 47.
[140] D'Arista, "Moving Beyond the Washington Consensus," 26.

firms, and strengthening of property rights.[141] By sponsoring these policy reforms, the United States hoped countries in the region would switch from the Latin American economic orthodoxy of the 1980s – inflation tolerance, import substituting industrialization, and a strong state presence – toward an economic orthodoxy championed by developed nations – macroeconomic discipline, market integration, and a market economy.[142] While these policies did work in some countries, as in Costa Rica, they did not bring meaningful change to the economies of other nations, such as Mexico and Honduras.

In the 1990s, Costa Rica continued to implement a series of structural reforms under the solutions provided by the Washington Consensus. Specifically, Costa Rica continued to privatize state-owned enterprises, liberalized its trade policies, and introduced a crawling peg exchange rate regime "based on daily mini-devaluations of the *colón.*" [143] At the end of the 1990s, the state had privatized most state-owned enterprises but kept its monopolies on electricity, telecommunications, oil refinement and distribution, insurance, and alcohol production. The state likewise began to liberalize its trade policy. It established free trade zones with free-tax regimes for multinational corporations with export purposes. Due to the introduction of these free trade zones, several technology, pharmaceutical, and service companies began to establish to invest in the country. Most notably, Intel chose Costa Rica to become the site for a microchip plant. The introduction of free trade zones proved to be a pivotal shift for the diversification of the nation's economy, as the country was able to replace its top exports, bananas and coffee, with semiconductors and computer accessories.[144]

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[141] Williamson, "The Strange History of the Washington Consensus," 196.
[142] Williamson, 197.
[143] Juan Carlos Hidalgo, "Growth without Poverty Reduction: The Case of Costa Rica," Economic Development Bulletin (Cato Institute, January 23, 2014), 1–2.
[144] Hidalgo, 1.

Costa Rica also began to negotiate free trade agreements with various countries. During the decade, Costa Rica was able to implement free trade agreements with Mexico, Chile, Peru, Panama, the Central American Common Market, the Caribbean Community, the Dominican Republic, Canada, China, Singapore and the European Union.[145] After a 2009 referendum, Costa Rica ratified CAFTA-DR, a free trade agreement with the United States, Central America, and the Dominican Republic.[146] Following the trend of a more liberal trade policy, the nation slashed most tariffs of consumer goods. In 1985, the mean tariff rate on consumer goods was 55 percent. By the end of the 1990s, the mean tariff rate was only 5.4 percent.[147] As seen, Costa Rica did not only introduce vast structural reforms during the 1990s, but likewise it pursued a liberalization of its trade policy, helping the nation become one of the strongest economic performers in Latin America during this period.

The effects of the structural reforms and trade liberalization were quickly felt throughout Costa Rica. The privatization of state-owned enterprises and the introduction of a crawling peg exchange rate regime led for the country to impressive growth in investment, total factor productivity, and significant economic diversification.[148] In the early 1980s, Costa Rica's agriculture sector constituted more than a quarter of GDP, however, after the introduction of the structural reforms, agricultural production reached a low of just over 8 percent of GDP by 2004.[149] Furthermore, the service sector grew significantly over the decade, achieving 50 percent growth in its share of GDP. Likewise, increased interest for the country's stability and

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[145] Hidalgo, 1–2.
[146] Raymond Hicks, Helen V. Milner, and Dustin Tingley, "Trade Policy, Economic Interests, and Party Politics in a Developing Country: The Political Economy of CAFTA-DR," *International Studies Quarterly* 58, no. 1 (March 2014): 106–17.
[147] Hidalgo, "Growth without Poverty Reduction: The Case of Costa Rica," 2.
[148] Agustín Carstens, "Twenty Years Without a Crisis in Costa Rica: The IMF's View" (Academy of Central America, Costa Rica, July 12, 2004), https://www.imf.org/en/News/Articles/2015/09/28/04/53/sp071204.
[149] Carstens.

environment led to an impressive rise in the country's tourism industry.[150] As seen, the 1990s, with the introduction of a series of significant Washington Consensus reforms and policies, led to a significant diversification of the nation's economy, as well as helping Costa Rica achieve significant economic growth, effectively becoming an outlier in the Central American region.

Following the examples of other nations, most Latin American nations partially or fully implemented Washington Consensus economic policies. However, unlike Costa Rica, some nations in Latin America failed to materialize the economic growth that was promised by the advocates of the Washington Consensus and multilateral financial organizations, primarily the IMF. After its disappointing economic performance in the 1980s, Honduras introduced a series of Washington Consensus policies to achieve some economic growth. In 1990, President Rafael Leonardo Callejas announced to the National Congress his plan to introduce structural reforms to the economy. Specifically, the policies pushed forward were: a devaluation of the currency, the *lempira,* a more liberal trade policy, antitrust legislation, an increase in taxes and a liberalization of interest rates.[151] As a result of the introduction of these structural reforms, Honduras achieved some short-term economic growth and some economic diversification. In 1990, the country's primary exports (bananas, coffee, sugar, tobacco, wood, and minerals) accounted $662 million U.S. dollars, while secondary exports (seafood, fruits, industrial products, gold, among others) only accounted $169 million U.S. dollars. However, by 2003, secondary exports accounted for $893 million U.S. dollars, while primary exports only accounted for $440 million dollars. As seen, some much-needed economic diversification was achieved by Honduras in the 1990s. The country was no longer heavily subject to the swings of international export markets due to

[150] Carstens.
[151] Eugenio Sosa Iglesias, "Transformaciones En Las Élites Económicas, Estado y El Proceso de Democratización y Desdemocratización," *Anuario de Estudios Centroamericanos* 43 (2017): 127.

agricultural product diversification, however one of the economy's primary issues remained unsolved, as agriculture continued to be the primary economic activity of the country. The nation-state likewise began to privatize various state-owned enterprises since the early 1990s. Since then, it has privatized enterprises such as the sugar refinery (ACANSA), the cement producer (INCEHSA), the national investment corporation (CONADI), as well as airports, construction companies, and road maintenance enterprises. The state has maintained its interests in the electrical grid (ENEE) and the telecommunications agency (HONDUTEL).[152]

While the Washington Consensus policies pushed forward by the United States and multilateral financial organizations did provide some short-term relief to the stagnant Honduran economy, it ultimately did not fix the deep structural issues present for most of its history. In 1995, the Interamerican Bank of Development (IDB) provided Honduras with a $160 million dollar loan for "modernization of the state." The primary goals of the program were a reform of public services, administrative reforms, and public administration reforms. Within these primary goals laid conventional Washington Consensus conditions such as the privatization of state-owned enterprises and a reduction of public sector employment.[153] In the words of the IDB, the loan was designed to "restore and maintain macroeconomic stability and improve efficiency in the state apparatus" [154] As seen, not only were the structural reforms introduced originally by the Honduran President in 1990, but they were continued through the decade with the support, or rather financial coercion, of the United States, the IMF, the World Bank, and the IDB. As much as these reforms were pushed forward by neoliberal presidents or foreigners, Honduras did not ultimately benefit much from the Washington Consensus.

[152] Sosa Iglesias, 133.
[153] "Public Sector Reform Program" (Washington, D.C: Inter-American Development Bank, December 20, 1995), 1, https://www.iadb.org/en/project/HO0101.
[154] "Public Sector Reform Program," 2.

After the liberalization of trade in 1990, Honduras was not able to keep up with the large surge in imports, as the domestic export markets was still primarily composed of agricultural products subject to market intervals. As a result, the country experienced a growing trade imbalance for most of the decade. At the same time, real interest rates were increased until 2002, further diminishing economic activity, and the real exchange rate continued to appreciate until the early 2000s, further complicating Honduras' position in a globalized economy.[155] The Washington Consensus reforms also did not address one of the primary structural issues the Honduran economy faces: its extreme dependence on agriculture as its primary economic activity. As of 2013, the agricultural sector still provided over one-third of jobs in the Honduran economy, making up over 55% of all employment opportunities in rural areas. Furthermore, stagnant agricultural production did not translate into higher wages for laborers, thus creating a cycle of stagnation with little economic competitiveness.[156] Furthermore, inequality in household per-capita income increased since 1991 for more than a decade, and only started to decrease after 2005. The growing inequality in household per-capita income is heavily influenced by an increase in rural inequality.[157]

While the economic performance of Honduras in the 1990s proved to once again be a disappointment, that does not mean that the Washington Consensus policies did not bring some benefits to the economy. A reduction of tariff rates, the opening of the Honduran economy to international competition, and the privatization of deficient state-owned enterprises were some of the benefits of the Washington Consensus. But with these policies came various issues the Honduran state was simply not ready to address. Rising gasoline and transportation costs created

[155] Carlos Villalobos Barría, *Economic Inequality in Latin America: Migration, Education and Structural Change* (Peter Lang, 2013), 28.
[156] Villalobos Barría, 29.
[157] Villalobos Barría, 38.

dents in consumers' pockets. The opening of the economy to international competition unexpectedly led to an increase in the prices for public services, electricity, water, and telephone plans, among others.[158] The structural adjustment of the 1990s also led to a rapid decay in union creation and membership, one of the primary laborer interest groups for collective bargaining. From 1955 to 2001, 446 unions were created in Honduras, however, by 2001, 261 unions were dissolved and only 185 remained active, accounting only 41% of all unions founded in the country.[159] The loss of unions in Honduras clearly affected workers' ability to demand higher wages, as the nation-state cracked down on unions in the name of neoliberalism and 'sound' economic policy. Ultimately, while the Washington Consensus did provide some short-term solutions for the Honduran state, it did not provide a long-term solution for the many structural problems which still plague the nation.

It seems that while Latin American countries' experiences with Washington Consensus policies have varied, the region has overall been harmed more than it has been helped. After all, prescribing a one-size-fits-all solution, like Rodrik previously noted, is bound to disappoint, and possibly bring more economic issues, as was the case in Mexico and Honduras. It is of critical importance to note that while the Washington Consensus was extremely popular among academic and policy circles in the early 1990s, multiple criticisms were quickly created in response to the policies pushed forward by the consensus. The birth of the Washington Consensus came in the late 1980s as a response to the sudden collapse of the Soviet Union. An overall disenchantment with socialist ideas and economic central planning created a vacuum for the Washington Consensus to fill, especially in providing an alternative set of ideas on how to

[158] Sosa Iglesias, "Transformaciones En Las Élites Económicas, Estado y El Proceso de Democratización y Desdemocratización," 127.
[159] Sosa Iglesias, 131.

organize a nation's economic and political structures.[160] Combined with the new U.S. position as the sole hegemon and its vast influence in multilateral financial organizations like the World Bank and the International Monetary Fund, as well as trade organizations like the World Trade Organization, the Washington Consensus was widely accepted through most of the world as the only option for development.

The legacy of the Washington Consensus is one of economic and political consolidation for Western powers, and one of short- and long-term economic pain for the underdeveloped world. Today, there is abundant and increasing evidence that the economic reforms advocated with the agenda of the Washington Consensus have failed to materialize into robust and consistent economic growth for the nations of the Global South.[161] It is interesting to contrast the growth of Latin American nations, which has remained mostly stagnant after the introduction of Washington Consensus policies, with the economic development of China and India, nations leading the world's economic development for the past three decades. China and India, countries that in no sense followed the neoliberal formula of the Washington Consensus, are proof that there is more than one prescribed path to development, and further provide evidence against the agenda the Washington Consensus pushes forward.[162] While it is easy to critique the Washington Consensus thirty years after it was first introduced, it must be acknowledged that the cash-strapped economies of the Global South did not have many options for financing and were often forced to accept IMF loan conditions to save their economies.

One final criticism of the Washington Consensus is that some authors consider it to be a byproduct of modern colonialism and a continuation of the imperial project. Considering the role

[160] Moisés Naím, "Washington Consensus or Washington Confusion?," *Foreign Policy* 118 (Spring 2000): 88.
[161] Ha-Joon Chang and Ilene Grabel, "Reclaiming Development from the Washington Consensus," *Journal of Post Keynesian Economics* 27, no. 2 (Winter, -2005 2004): 274.
[162] Chang and Grabel, 277.

of the United States as the single hegemonic capitalist nation in the current international arena after the collapse of the Soviet Union, Washington-based financial institutions like the International Monetary Fund and the World Bank act as functionaries of the interests of the sole hegemon. As a result, these financial institutions prescribe policy reforms and solutions that might not actually work or are in the interest of the "dominant firms of the hegemonic power" [163] To best serve its interests, the sole hegemon often deploys its power and influence to advance a certain policy view, effectively imposing liberalism in nations with no other recourse.[164] The voices of local governments, non-governmental organizations, and populations are mostly ignored. This has been the case in all, if not most of Latin America, as cash-strapped nations, like Costa Rica and Honduras, are often left at the behest of the IMF and the World Bank for financing, and in turn, these organizations demand adherence to a predetermined neoliberal model of economic development.

Honduras and Costa Rica: 1990s Economic Divergence

In 1990, the Costa Rican and Honduran economies began to diverge, with the Costa Rican economy achieving impressive economic growth for the following 30 years while Honduras remained mostly stagnant. Looking at economic data from the World Bank, specifically Gross Domestic Product data, it can be concluded that in 1990 Costa Rica and Honduras enjoyed similar GDPs, as shown by Figure 1. However, in the years after 1990, data shows a divergence between both countries' GDPs. In 2020, Costa Rica's economy is about 2.5 times the size of Honduras', as seen in Figure 1, leading me to question which factors have

[163] Robert E. Prasch, "Neoliberalism and Empire: How Are They Related?," *Review of Radical Political Economics* 37, no. 3 (Summer 2005): 285.
[164] Prasch, 284.

contributed to this growth divergence.[165]

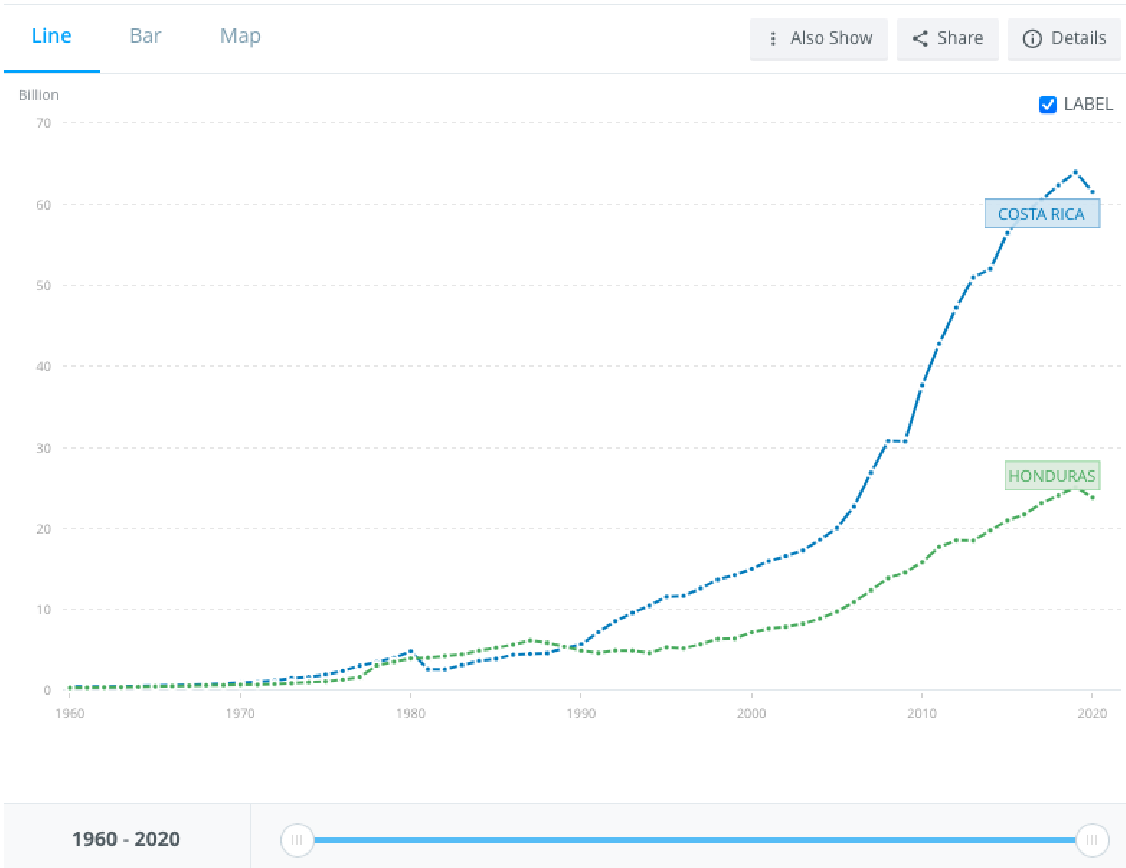

Figure 1: GDP (current US$) – Costa Rica, Honduras
Source: The World Bank

While looking at GDP data provides some clues into the story of how Costa Rica has become so rich while Honduras has remained relatively poor, it is also important to look at other economic indicators other than GDP. For example, GDP per capita data tells a very similar story. In the late 1980s, Costa Rica and Honduras had similar GDPs per capita, just under $2,000 U.S. dollars per year. In 2020 however, Costa Rica's GDP per capita is around $12,000 per year while

[165] "GDP (Current US$) - Costa Rica, Honduras" (World Bank, 2021), https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=CR-HN.

Honduras' GDP per capita remains stagnant at just over $2,000 per year.[166]

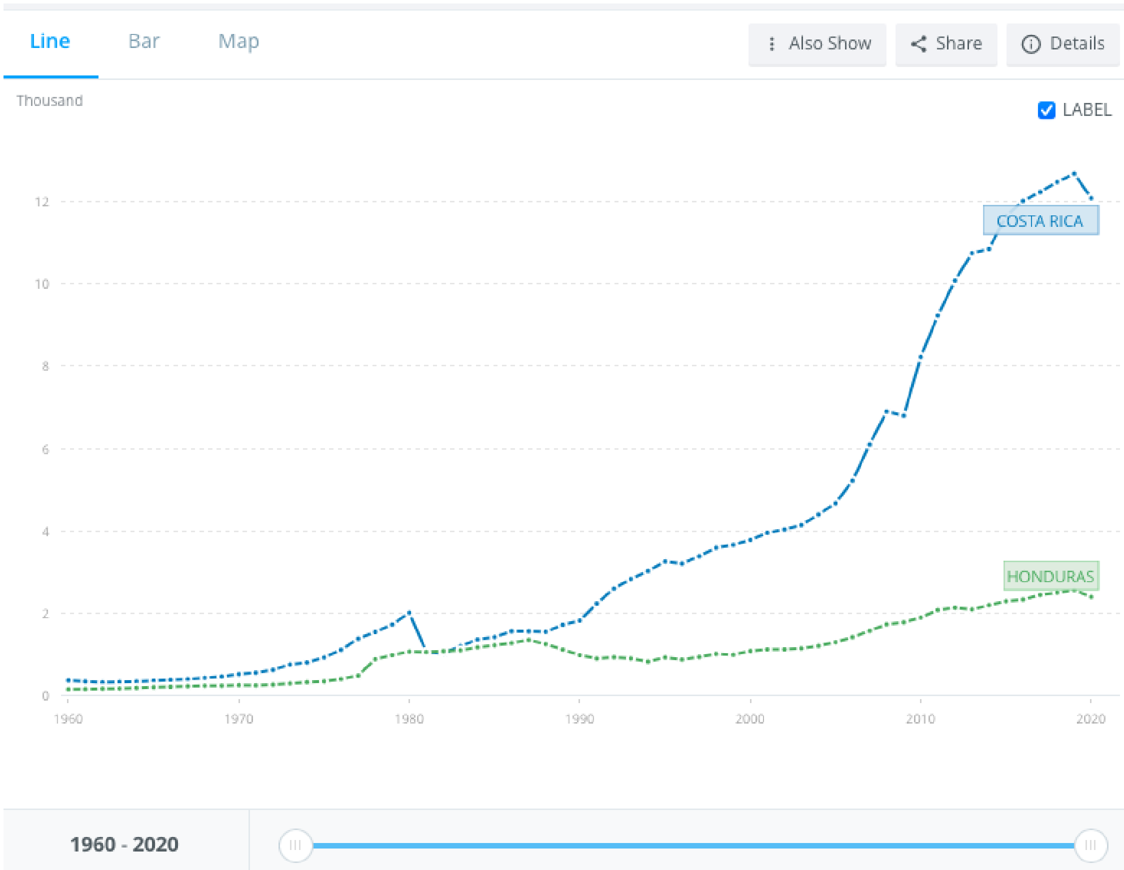

Figure 2: GDP per capita (current US$) – Costa Rica, Honduras
Source: The World Bank

From this data it can be inferred that something occurred in Central America in the late 1980s to early 1990s for this significant economic divergence to occur. One of the primary questions I seek to answer is why this divergence occurred and what are some of the factors driving such divergence. Taking into account the traditional schools of development theory, geography, trade, and institutions, this paper will pursue a New Institutional Economics

166 "GDP (Current US$) - Costa Rica, Honduras."

approach to explain the economic divergence between Costa Rica and Honduras. Specifically, this paper will claim that Costa Rica's superior political institutions relative to Honduras has allowed the economy to grow significantly since 1990, while Honduras has not been able to do so. The structural economic reforms of the 1980s are of particular interest as they set the stage for the impressive Costa Rican economic growth post-1990 and will likewise provide evidence to what went wrong in Honduras's development pursuits. After all, if both nations enjoy similar geographies, openness to international trade, and implemented Washington Consensus reforms, surely institutions, particularly political ones, have played a pivotal role in the diverging histories of these two Central American nations.

New Institutional Economics: Costa Rica and Honduras Explained

New Institutional Economics

The mixed successes of the Washington Consensus led to a reevaluation of mainstream economic growth theories. In the 1990s, a field of literature known as New Institutional Economics arises, with the goal of explaining the role institutions play in economic development and growth trajectories. Seeking to challenge more conventional theories of development, particularly geography and integration, New Institutional Economics garnered extensive support by a number of authors, specifically Douglass North, Joseph Stiglitz, Daron Acemoglu, and James Robinson. Prior to explaining how a difference in political institutions has influenced the Costa Rican and Honduran economic growth prospects, it is important to lay out the theory pushed forward by New Institutional Economics, specifically to note the connection between institutions and economic growth.

To explain economic growth, Douglass North lays out the foundations of New Institutional Economics in his 1994 article *Economic Performance Through Time.* Through an inspired account of human history, North highlights the role that institutions have played in most humans' lives, from how they manage their household to how they collectively run the economy. Some of the conclusions reached by North are that institutions form the incentive structure of society, and as a result, political and economic institutions become the underlying determinants of economic performance.[167] Institutions act as constraints on human behavior,[168] as they might impede a person in power from pursuing a certain action or policy that might not be in the best

[167] Douglass North, "Economic Performance Through Time," *The American Economic Review* 84, no. 3 (June 1994): 359–60.
[168] Christopher Clague, "The New Institutional Economics and Economic Development," in *Institutions and Economic Development*, ed. Christopher Clague (Baltimore, MD and London, UK: The Johns Hopkins University Press, 1997), 17.

interest of the nation, much like developed systems of checks and balances work in the developed Western World. In turn, the expected lives of institutions (constraints) are much higher than the expected lives of policies.[169] Thus, institutions not only serve as a roadblock against bad policy, but also are expected to outlast the effects of such bad policy. Institutions serving as constraints on human behavior occur, for the most part, in nations with well-developed democracies and robust economies. For the rest of the world, institutions are rather seen as pets under the ruler's mandate, for he or she can manipulate institutions in his or her favor. Therefore, institutions are not necessarily built to be socially efficient, as they are created to serve the interests of those who have the bargaining power to create new rules in a society.[170] In developed nations, multiple organizations share the bargaining power, whether it be Members of the National Legislature, the President's administration, independent judges, lobbying groups, and various other interest groups. Together, they create the rules of the game, in this case, the rules of political discourse and economic policy. In contrast, in less developed nations, bargaining power is concentrated in the hands of a select few, often the head of state, his or her family, and other high-ranking ruling party officials.

North argued that the interactions between institutions and organizations are what shapes the institutional evolution of an economy.[171] Granted, if power is concentrated in the hands of a select few who are seeking to maintain and grow their material interests, much institutional evolution should not be expected, as it will go against the interests of those powerful few. Therefore, with little institutional evolution and an already relatively weak institutional arena, much economic growth should not be expected from nations where power is heavily

[169] Sebastian Dellepiane-Avellaneda, "Good Governance, Institutions and Economic Development: Beyond the Conventional Wisdom," *British Journal of Political Science* 40, no. 1 (January 2010): 203–4.
[170] North, "Economic Performance Through Time," 360–61.
[171] North, 361.

concentrated. However, North further argued that even if power is concentrated in the hands of the few, that does not mean that the rules of the game cannot be changed. While the vast majority of policy decisions reached by political elites are routine and continue the existing structures of political and economic power, some decisions "involve altering existing 'contracts' between individuals and organizations.'[172] As a result, an alteration of the rules can be accomplished within the existing structure of property rights and the political rules, affecting the underlying institutions of political and economic power. Such alterations occur when individuals perceive that they could do better by instituting changes in the institutions. Often, the change in individuals' perceptions is due to an exogenous shock, such as a change in the country's terms of trade or a change in the price of imports.[173] North's recognition of the role that institutions play in economic development was pivotal for the birth of New Institutional Economics, as a new way of thinking about development was needed to fill the vacuum left by the mixed success of the Washington Consensus. North's account of history deserves some recognition in that he considers how institutions evolved simultaneously with human progress:

> As tribes evolved in different physical environments, they developed different languages and, with different experiences, different mental methods to explain the world around them. The languages and mental modes formed the informal constraints that defined the institutional framework of the tribe and were passed down intergenerationally as customs, taboos, and myths that provided cultural continuity… With growing specialization and division of labor, the tribes evolved into polities and economies; the diversity of experience and learning produced increasingly different societies and civilizations with

[172] North, 361.
[173] North, 361–62.

> different degrees of success in solving the fundamental economic problems of scarcity. The reason is that as the complexity of the environment increased as human beings became increasingly interdependent, more complex institutional structures were necessary to capture the potential gains from trade. Such evolution requires that the society develop institutions that will permit anonymous, impersonal exchange across time and space. To the extent that culture and local experiences had produced diverse institutions and belief systems with respect to the gains from such cooperation, the likelihood of creating the necessary institutions to capture the gains from trade of more complex contracting varied. In fact, most societies throughout history got 'stuck' in an institutional matrix that did not evolve into the impersonal exchange essential to capturing the productivity gains that came from the specialization and division of labor that have produced the Wealth of Nations.[174]

From the recognition that institutions have developed alongside humans for most of human history, North concludes that the mixture of formal rules, informal norms, and enforcement in a nation shapes its economic performance. Institutions' long-lasting effects on economic performance are due to the fact that the formal rules may be changed overnight, however, the informal norms of institutions and power broking change only gradually.[175] Since North's groundbreaking scholarship, multiple other authors have theorized about the role of institutions in economic development, as well as applied empirics to the question at hand. Specifically, Knack's and Keefer's "Institutions and Economic Performance" built on data for 97 countries and concludes that the quality of institutions, measured by property rights and the level

[174] North, 363–64.
[175] North, 366.

of contract enforcement, is crucial to growth and investment. In “Corruption and Growth,” Mauro argued that corruption is negatively linked with investment and economic growth.[176] While several authors have worked to expand the reach and depth of New Institutional Economics, the biggest contributors to the field are Daron Acemoglu and James A. Robinson, authors of *Economic Origins of Dictatorship and Democracy* and *Why Nations Fail,* both seminal works for the literature.

In *Economic Origins of Dictatorship and Democracy,* Acemoglu and Robinson deep dive into the origins of power in a society. First, the authors differentiate between two types of political power: de facto and de jure. De facto political power refers to the power an individual or group possesses in a society using brute force, such as influence over the military, private armies, or mercenaries. In contrast, de jure political power refers to political power allocated by political institutions, such as winning an election or referendum.[177] This distinction between forms of political powers is essential to understand how everyday citizens, elites, and institutions interact in the political arena. While democracy and autocracy are inherently different, it must be noted that both systems of governance possess a combination of de jure and de facto political power. It is from the combination of de facto and de jure political powers in a society that determines the actual power of an individual or a group determining which economic institutions and policies arise.[178] Those who hold the majority of political power will make decisions to maximize their material interests and to maintain their grip on power. In autocracies, political power lays in the hands of the political elite, who are often also the economic elite of society. In democracies,

[176] Dellepiane-Avellaneda, “Good Governance, Institutions and Economic Development: Beyond the Conventional Wisdom,” 198–99.
[177] Daron Acemoglu and James A. Robinson, *Economic Origins of Dictatorship and Democracy* (Cambridge, UK and New York, NY: Cambridge University Press, 2006), 21.
[178] Karl Ove Moene, “Are Good Policies Good Politics,” in *Governing the Global Economy: Politics, Institutions, and Economic Development,* ed. Dag Harald Claes and Carl Henrik Knutsen (London, United Kingdom: Routledge, 2011), 162.

political power is spread out through society and lays at the hands of civilians who hold electoral power, special interest groups, among others.

In autocracies, political and economic power is held by a select few. However, it is inappropriate to claim that citizens in autocracies do not hold any political power. Rather, citizens in autocracies possess de facto political power rather than de jure political power. Elites monopolize on de jure power, through the political and economic institutions they establish, but not de facto power.[179] Citizens still form the majority of the nation's population, granting them power of the masses. The citizens thus can pose challenges to the system by organizing and claiming greater representation and visibility in the political arena. De facto political power of citizens in autocracies usually manifests through social unrest and turbulence and may even pose a revolutionary threat. However, this cannot occur without the organization of citizen groups, posing a formidable challenge for everyday citizens. Nonetheless, even among the challenges, Acemoglu's and Robinson's contributions to the literature regarding power broking has proven monumental in the pursuit of explaining the connection between institutions and economic development. After all, if power is concentrated in the hands of the very few, as they are in autocracies, economic policies for the benefit of those in power will be the norm. It is not until everyday citizens claim their place in the political arena that inclusive economic policies that advance the nation's economy will be introduced and enacted.

Before applying New Institutional Economics to explain the 1990 economic divergence between Costa Rica and Honduras, it is useful to provide some definitions that will guide my argument. First, in New Institutional Economics, institutions are defined "as socially devised constraints on individual action. They are sets of rules that are recognized and frequently

[179] Acemoglu and Robinson, *Economic Origins of Dictatorship and Democracy*, 25.

followed by members of the community and that impose constraints on the actions of individual members." [180] In developed nations, institutions are stronger and robust, whereas in developing nations, institutions tend to be weak and corrupt. That is not to say that all developing nations have weak and corrupt institutions, as there are notable exceptions like Costa Rica and Rwanda, but these are exceptions rather than the norm. Most developing nations have nascent institutions that prevent their economies from achieving robust and sustained economic growth. Second, a nation with strong political institutions does not necessarily have to be a democracy. There are numerous examples of autocracies, particularly China, that have achieved impressive economic growth under the rule of the authoritarian political parties, yet it would be improper to call China's strong political institutions "democratic." Rather, it must be recognized that strong institutions do not mean democracy, as a nation can be democratic and possess weak institutions. This would be most normal in post-Socialist states with little autonomous political development up until the collapse of the Soviet Union, primarily Eastern Europe, and in post-colonial states that have not yet achieved sustained economic growth, such as in Latin America and Africa. Lastly, it is important to note that New Institutional Economics suffers from a causality problem, as the literature has struggled to show that strong political institutions are the drivers of economic growth rather than strong political institutions being a byproduct of a nation with a strong economy.[181] With these definitions in mind, a New Institutional Economics explanation can be provided to explain the 1990 economic divergence between Costa Rica and Honduras.

Diverging Political Institutions: Costa Rica and Honduras

While Costa Rica and Honduras were both part of the Spanish Empire, then part of the

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[180] Clague, "The New Institutional Economics and Economic Development," 17.
[181] Dellepiane-Avellaneda, "Good Governance, Institutions and Economic Development: Beyond the Conventional Wisdom," 200.

Federal Republic of Central America, and eventually became independent states, their political development have varied significantly since independence into the present. For example, Costa Rica has been able to maintain continued democratic rule since 1949.[182] In contrast, the rest of the region has experienced sociopolitical crises which have impeded continued democratic rule, such as armed conflict in the 1980s in Nicaragua, Guatemala, and El Salvador, and the 2009 Honduran coup d'état. From these simple facts, it seems that Costa Rica has fared much better than its neighbors in terms of democratic and political institutions. Its continued democratic rule has allowed the country to invest in its institutions and its people, thus providing a possible explanation for the country's impressive economic growth post 1990.

The role of institutions in Costa Rican economic development is thus supported by the region's history of political development. If we take the other two schools of thought into consideration, both theories, geography and integration, fall flat and do not explain the economic differences between Costa Rica and Honduras. The geography theorists argue that a country's location and natural resources are the main determinants of economic growth. Yet, that does not seem to be the case for the two Central American nations studied. Costa Rica and Honduras are in the same region, with only one country between them, Nicaragua. Both countries enjoy similar climates, topographies, and natural endowments. Before 1990, primary exports were coffee and bananas for both countries, thus there seems not to be any significant geographic differences between Costa Rica and Honduras. The integration advocates say that international trade is the primary determinant of growth for nations, and center market integration above all else. Similarly, this theory does not seem to explain the divergence between Costa Rica and Honduras well. Both nations enjoy most favored nation status and are subject to the same free trade

[182] Sada, "The Curious Case of Costa Rica: Can an Outlier Sustain Its Success?," 11.

agreement (FTA) with the United States, the Dominican Republic-Central America Free Trade Agreement (CAFTA-DR), signed in 2004.[183] Both nations are also members of the Central American Common Market, an organization seeking to promote economic integration via free trade in Central America, since the 1960s. Thus, while both theories might have explained economic growth in the past, they do not seem to explain the current state of Central American economic growth. Because of the lack of applicability of the aforementioned theories, it is necessary therefore to conduct a New Institutional Economics approach to the question of economic development in the region. The study can provide guidance for Central American nations seeking sustained economic growth in the long term, as well as some short-term economic remedies.

A shared colonial history, similar racial and ethnic compositions, natural endowments, and geographies do not provide an explanation for the 1990 divergence between the Costa Rican and Honduran economies. Strong and robust political institutions provide an explanation for the 1990 economic divergence. During the 1980s, both nations underwent a series of structural adjustment reforms advocated by the International Monetary Fund, the World Bank, and USAID under the premises of the Washington Consensus. As a result, both nations privatized a good portion of their state-owned enterprises, as well as implemented key economic reforms regarding trade liberalization, exchange rates, and interest rates. Ultimately, the Washington Consensus reforms aided Costa Rica's economic growth, as it has grown significantly for the past 30 years, far outpacing its Central American peers. Honduras has remained stagnant even with the implementation of Washington Consensus policies. Thus, as seen, 'good' policies are not the sole determinant of economic progress, as a nation, like Honduras, can implement structural

[183] Mechel S. Paggi et al., "Regional Trade Agreements and Implications for US Agriculture: The Case of CAFTA-DR," *Choices* 20, no. 2 (2005): 137.

adjustment reforms and not achieve any significant improvement to its economy, continuing its cycle of dependency and economic disappointment. Thus, from the experience of Costa Rica and Honduras, it can be inferred that strong and effective political institutions are needed to complement macroeconomic policy changes.[184] In fact, there seems to be a growing consensus in the literature about the role institutions play in economic development and its policies. Authors, like Moisés Naím, have been quick to call out the effect of institutions, particularly weak ones, on economic development:

> Public sector institutions are the black holes of economic reforms. In most countries they absorb efforts and investment that yield obscenely low returns to society, distort labor markets, reduce countries' overall productivity, impair international competitiveness, and easily fall prey to vested interests. Public institutions are often at the center of the corruption that corrodes the political system.[185]

With the recognition of the role of public institutions on economic growth prospects, and particularly the dangerous nature of weak public institutions, we can now direct our attention to institutional differences between Costa Rica and Honduras. Following North's assertions about the long-standing impacts of institutions, formal rules, and informal norms on political behavior and policy making, it is imperative to once again revisit some of the political developments in Costa Rica and Honduras. After independence from the Spanish Crown and the Mexican Empire, Costa Rica and Honduras underwent significant political and economic changes that have impacted the country's institutions into the future. When both nations were part of the Federal

[184] Naím, "Washington Consensus or Washington Confusion?," 93.
[185] Naím, 99.

Republic of Central America, an exogenous shock happened in the region that changed the incentive structure and thus, political institutions. In the 1830s, coffee was introduced to Costa Rica and spread to El Salvador by the 1860s.[186] With the introduction of coffee, the incentive structure of Costa Rican elites was changed, as coffee revenues served "as an economic base for such elite consensus." [187] North's assertions regarding how political institutions can change within the existing political system deserve some recognition here. North argued that modifications can occur to political institutions and the incentive structure that shapes them if the individuals in power perceive that they could do better by instituting changes.[188] This was the case in Costa Rica in the 1830s. Political elites recognized the value of commercial expansion via coffee revenue, as they could greatly benefit from the trade's profits. Rather than continue the political infighting regarding the formation and establishment of an independent Costa Rican Republic, political elites focused heavily on maximizing their personal profit from the newly established coffee trade. This was not the case in Honduras, however. Coffee was not introduced to the country as early as it was introduced to Costa Rica. As a result, political elites continued fighting among themselves, instigating political violence and regional instability, preventing the nation from taking part in the early economic benefits of commercial coffee production.[189] The introduction of coffee to Costa Rica led the crop to become the nation's leading export by the end of the 19th century, unlike in Honduras, where stock raising and banana production remained the primary economic activities.[190]

While coffee was not introduced to Honduras as early as it was to Costa Rica, bananas,

[186] Ropp and Morris, *Central America: Crisis and Adaptation*, 15.
[187] Ropp and Morris, 15.
[188] North, "Economic Performance Through Time," 361–62.
[189] Ropp and Morris, *Central America: Crisis and Adaptation*, 15.
[190] Ropp and Morris, 18.

another important cash crop, proved to be another institutional determinant in Central America. Bananas can be traced back to Honduras as early as the 1840s, when British explorers found thousands of banana trees along the Río Negro in Northern Honduras.[191] Throughout the rest of the century, banana production spread throughout the country, helping consolidate political and economic power in the hands of a few landed Honduran elites. The consolidation of power primarily occurred after the 1870s, when President Marco Aurelio Soto enacted the Agrarian Law of 1877, which provided tax cuts and other economic incentives for farmers to grow crops for international markets.[192] With the enactment of the Agrarian Law, bananas became the primary export of Honduras by the end of the nineteenth century. However, bananas did not manage to stop political violence in Honduras, as coffee did in Costa Rica. Rather, caudillos, who deposed other caudillos from power, continued to be the norm through the twentieth century.

This early institutional divergence, regarding the reduction of political violence and elite infighting after the introduction of coffee, between Costa Rica and Honduras sets the stage for the massive economic takeoff Costa Rica was able to accomplish after the 1990s. While sustained economic growth would not be achieved for over a century, this early institutional divergence provides some insights into the early formations of the informal institutions referred to by North, as political elites were able to recognize the value of economic production and compromise over political disagreement in Costa Rica, yet not in Honduras. In North's own words, "informal constraints (norms, conventions, and codes of conduct) favorable to growth can sometimes produce economic growth even with unstable or adverse political rules." [193] Costa

[191] John Soluri, *Banana Cultures: Agriculture, Consumption, and Environmental Change in Honduras and the United States*, Second (Austin, TX: University of Texas Press, 2005), 18.
[192] Soluri, 19.
[193] North, "Economic Performance Through Time," 367.

Rica's early formation of informal institutional structures of elite reconciliation over shared interests formed the foundation for political discourse and economic distribution in the country.

The introduction of coffee to Costa Rica was pivotal for the country's economy and early formal and informal institutions. In the changes it brought to the economy, coffee created a wealthy landowner class, an aspect foreign to the country prior to the 1830s, as most of the population was poor subsistence farmers.[194] With the consolidation of wealthy coffee farmers and increasingly concentrated land ownership, a new social class emerged within Costa Rica. The landless agricultural workers, while representing a small part of the population, played a crucial role in the institutional development of the country. Until the 1880s, Costa Rica experienced a shortage of agricultural labor, resulting in high wages for the landless workers available. As a result, the landless agricultural workers were, for the most part, not impoverished. However, it was not until the landless agricultural workers demanded high wages that they were granted by the landed elite, helping create the informal norm of seeking compromise across social class.[195] [196] As Vega Carballo puts it:

> Because peasants and artisans… were not mere servile employees or passive instruments of exploitation… it was therefore necessary to elaborate a series of subtle psycho-social, symbolic, and normative ('soft') mechanisms in order to guarantee that they could be *persuaded* to work. [197] [198]

[194] Lowell Gudmundson, "Peasant, Farmer, Proletarian: Class Formation in a Smallholder Coffee Economy, 1850-1950," *The Hispanic American Historical Review* 69, no. 2 (May 1989): 223.
[195] Lehoucq, *The Politics of Modern Central America: Civil War, Democratization, and Underdevelopment*, 19.
[196] John A. Booth, "Costa Rican Democracy," *World Affairs* 150, no. 1 (Summer 1987): 44.
[197] José Luis Vega Carballo, *Poder Político y Democracia En Costa Rica* (San Jose, Costa Rica: Editorial Porvenir, 1982), 30.
[198] Booth, "Costa Rican Democracy," 44.

From this early connection between the informal institution of compromise across social classes and the economic outcome of higher wages for landless agricultural workers, it can be seen how political institutions have shaped economic outcomes in Costa Rica since the 19th century. Because resource allocations, in this case the landless agricultural workers' wages, occurred within institutions, in this case an early agrarian economy, the rules governing institutions are critical, in this case the Costa Rican elites' decision to grant higher wages.[199] With banana production in Honduras, landless agricultural workers were the norm, as wealth was heavily concentrated in the hands of a few for all Honduran history until that point. However, Honduran landless agricultural workers were not able to demand higher wages, as growing export bananas in the late nineteenth century did not require large inputs of labor.[200] Thus, the informal norm of compromise across social classes did not develop in nineteenth century Honduras, unlike Costa Rica. From the recognition that there is indeed a connection between political institutions and economic outcomes, we can now begin to craft the connections between political institutions and the 1990 economic divergence between Costa Rica and Honduras.

As seen, since its early rule, Costa Rica has been able to develop relatively egalitarian informal institutions, primarily informal norms controlling public discourse and discouraging political violence, that have helped shape the nation's political institutions. The same cannot be said for Honduras. Rather than engaging with the early coffee trade, which expanded throughout the region by the 1860s, Honduras' political elites continued their political infighting, depriving the nation from much-needed political development. While the institutional divergences between

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[199] Joseph Stiglitz, "Markets, States, and Institutions," in *Markets, Governance, and Institutions: In the Process of Economic Development*, ed. Ajit Mishra and Tridip Ray (Oxford, UK and New York, NY: Oxford University Press, 2018), 15.
[200] Soluri, *Banana Cultures: Agriculture, Consumption, and Environmental Change in Honduras and the United States*, 20.

Costa Rica and Honduras in the 19th century are to be noted, it must be recognized that these formal and informal political institutions are not the root cause of the 1990 economic divergence. Over 100 years passed between the success of the coffee trade and the 1990s economic divergence, suggesting that other institutional differences will provide better explanations for the economic divergence. However, it must be said, that New Institutional Economic claims that existing institutions will deeply influence the institutions of the future, in the same manner that pre-existing institutions have shaped present ones.[201] As North puts it, "Time as it relates to economic and societal change is the dimension in which the learning process of human beings shapes the way institutions evolve." [202] It is to be noted, therefore, that the institutions of the 19th century shaped the institutions of 20th century Central America. The path dependency of political institutions reinforces Antonelli's (1997) arguments, where he concludes that the state at present is dependent on both the state in the past and how that has changed over time.[203] Thus, the political institutions of the past have deeply influenced the current institutions of both Costa Rica and Honduras. It must be recognized that both countries were not only subjected to the ongoings within their respective nations, but were also part of a world becoming much more liberal, where new ways of thinking became common, deeply impacting the minds of their populations, thus shaping and changing the course of both nations' institutions going into the 20th century.

Costa Rica's formal and informal institutions of the 19th century shaped political discourse even before the arrival of democracy to the country in 1948. Since most Costa Ricans recognized their fundamental worth as citizens, due to the relatively egalitarian distribution of

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[201] Christopher Clague et al., "Democracy, Autocracy, and the Institutions Supportive of Economic Growth," in *Institutions and Political Development: Growth and Governance in Less-Developed and Post-Socialist Countries*, ed. Christopher Clague (Baltimore, MD and London, UK: The Johns Hopkins University Press, 1997), 98.
[202] North, "Economic Performance Through Time," 359–60.
[203] Cristiano Antonelli, "The Economics of Path-Dependence in Industrial Organization," *International Journal of Industrial Organization* 15, no. 6 (October 1997): 643–75.

wealth of the 19th century as a result of the coffee trade, they were not afraid to demand greater representation in the political sphere in the 20th century, even under autocratic regimes. Since 1905, political instability within the Costa Rican polity has brought more democracy and greater suffrage for the country's landless and poor.[204] Meanwhile, influenced by its formal and informal institutions of the 19th century, Honduras continued down its disastrous path of elite infighting and engaged in armed conflicts with neighboring states. For example, General Terencio Sierra, who was appointed Honduran President in 1899, was overthrown by Manuel Bonilla in 1903.[205] Under Bonilla's rule, Honduras fought a war against Nicaragua and threatened to attack El Salvador. As a result, Guatemala sought to overthrow Bonilla, with help from El Salvador.[206] As seen, not much changed in Honduras since the 19th century, as political elites continued their infighting, and now sought a destructive path of engaging in wars against other Central American nations, showing the vast influence of the political institutions of the past in those of the present.

Throughout most of its history, up until 1980, Honduras' system of governance was one of military despotism where effectively all branches of government were under the absolute control of the head of state.[207] Meanwhile, while Costa Rican democracy was not born until 1948, preexisting institutions of cooperation and egalitarianism preceded the establishment of continued democratic rule. This was not the case in Honduras. Elites still controlled much of the economy, and most of the population was impoverished and landless. This combination of caudillo politics and vast impoverishment shaped the political institutions of Honduras for most

[204] Ropp and Morris, *Central America: Crisis and Adaptation*, 155.
[205] Dana G. Munro, *The Five Republics of Central America: Their Political and Economic Development and Their Relations With the United States* (Oxford, UK and New York, NY: Oxford University Press, 1918), 123.
[206] Munro, 123.
[207] Munro, 125.

of the 20th century, preventing the nation from achieving sustained economic growth. As an example of the elites' influence in the Honduran state, during the 1910s the government started giving away generous concessions to foreign investors for banana production. Specifically, railroad concessions were granted to U.S. fruit companies, which helped these companies to establish vast control of resources. Honduran elites benefitted greatly from the foreign investment, as they believed that railroads would link the North Coast's banana success to the political power concentrated in Tegucigalpa, further advancing the elites' material interests.[208] The practices of the banana industry sewed corruption into the fabric of the Honduran state, establishing the practice of bribing government officials while pursuing self-enriching land policies.[209] While some attempts were made by several administrations to implement institutional changes to the country's political structures, these attempts mostly failed, as remnants of caudillo politics continued to plague administrations well past the 1960s.[210] The continuation of nascent political institutions in Honduras relative to those of Costa Rica are of severe importance to the 1990 economic divergence between both nations, as both nations seem not only to be on a predetermined economic growth path but also an institutional growth path, where the past deeply influences the future.

From the mid twentieth century, the Costa Rican government greatly extended its role in the country's economy. The basic economic premise the country followed was that unfettered capitalism "causes socioeconomic dislocations and inequalities that produce social ills and unrest." [211] Thus, since 1948, the government has vastly expanded its role across the economy,

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[208] Soluri, *Banana Cultures: Agriculture, Consumption, and Environmental Change in Honduras and the United States*, 43.
[209] Sarah Chayes, *When Corruption Is The Operating System: The Case of Honduras* (Washington, D.C: Carnegie Endowment for International Peace, 2017), 9–10.
[210] Ropp and Morris, *Central America: Crisis and Adaptation*, 199.
[211] Ropp and Morris, 170.

amassing interests in banking, insurance, most public utilities, petroleum refining, railways, ports, and some urban mass transit. By 1984, the Costa Rican government accounted for 60 percent of Gross National Product.[212] In contrast, since Honduras was still under the control of the military until 1980, public investments were minimal. For most of the century, the Honduran state was not engaged in the distribution of material wealth, as it still sought to protect the material interests of landed political elites. However, the country did manage to invest in infrastructure and reduce its public debt through the 1930s and 1940s.[213] It is important to note that the Costa Rican government's disposition to heavily invest in its economy stems from the country's long egalitarian history, which has simply not been the case in Honduras.

The mid twentieth century was a period of widespread corruption through the Honduran state. While all forms of governments, democracy or autocracy, are subject to political corruption, strong institutions function as a counterbalance, creating an equilibrium. In contrast, in nation-states where institutions are weak, institutions are a mere formality that do not have the capacity to root out corruption, and much less conduct investigations or punish actors.[214] In Honduras, corruption was persistent and widespread as a result of the networks built between the nation-state, political parties, and the country's elites. With these networks of interconnectedness between those in power underlying the country's political institutions, liberty, pluralism, and the rule of law were nothing more than fiction.[215] Because of the legacy of banana caudillo politics, President Tiburcio Carías Andino, a former general, prevented the enactment of robust

[212] Ropp and Morris, 170.
[213] Chayes, *When Corruption Is The Operating System: The Case of Honduras*, 10.
[214] Julieta Castellanos, "Corrupción y Debilitamiento Institucional: Amenazas Para La Democracia" (Federación de Organizaciones Para El Desarrollo de Honduras (FOPRIDEH), November 2007), 6, https://foprideh.org/documentos/pdf/Libros/III%20INFORME%20DE%20CORRUPCION%20EN%20HONDURAS.pdf.
[215] Sosa Iglesias, "Transformaciones En Las Élites Económicas, Estado y El Proceso de Democratización y Desdemocratización," 135.

democratic institutions, continuing the longstanding pattern of protection of elite interests.[216] In 1963, Colonel Oswaldo López Arellano, the commander of the Air Force, exercised a coup, changing the course of the country. Honduras' Constitution was abolished, a new Constituent Assembly was formed and tasked with the creation of a new Constitution.[217] Under López Arellano's rule, Honduran elections were fraudulent, and corruption became even more widespread. After popular protests occurred following the fraudulent municipal elections of March 1968, the Honduran state brutally repressed its citizens, effectively shutting down dissent in the country.[218] Another aspect of the López Arellano's Presidency was the funneling of state money into his own pockets and those of his associates, stealing development aid monies from the United States.[219] Honduras did not create corruption nor is it the only nation-state in the world to have consistent problems with it, but corruption is unique in Honduras in the sense that, governments, rather than seeking to root out corruption from the political system, seem to seek its manifestation as it continues to advance the elites' material interests because of the legacies of the corruption networks created in the 19th century.

Costa Rica, on the other hand, since 1948, with the establishment of continued democracy, does not experience the widespread corruption Honduras deals with on a continued basis. Since 1948, all Presidents have honored the Constitution and all political parties have sought to promote the value of democracy. Notably, Costa Rican society is distinguished by its large number of formal organizations which have direct stakes in government policy. This distribution of power among formal organizations, led by ordinary citizens, is not new in Costa

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216 Chayes, *When Corruption Is The Operating System: The Case of Honduras*, 10.
217 Thomas P. Anderson, *Politics in Central America: Guatemala, El Salvador, Honduras, and Nicaragua* (New York, NY: Praeger Publishers, 1982), 113.
218 Anderson, 114.
219 Anderson, 113.

Rica, as it represents the legacies of the collaborative informal institutions of the 19th century. In a 1973 national survey, Costa Rican heads of family reported a mean of 1.52 organizations membership each.[220] Since the establishment of democracy in the country, repression as a response to demands has been extremely rare, as the government is responsive to many organizations' demands.[221] As seen, Costa Rica's setting in the mid-20th century was rather privileged relative to Honduras. Corruption, while it did occur, was not systematic, and much less a network among the country's elite. These are the institutional settings in which Costa Rica and Honduras experiences economic downturns in the 1980s, and subsequently implemented Washington Consensus reforms in the 1990s. As seen, Honduras' political institutions, ravaged with corruption, were significantly weaker than the political institutions of Costa Rica, which had been fostered by a long-standing informal norms of collaboration and relative egalitarianism. It is because of these institutional divergences between Costa Rica and Honduras that Costa Rica was better suited to achieve sustained economic growth with the implementation of Washington Consensus reforms. Honduras, because of its weak and corrupt political institutions, continues to remain stagnant today, relative to other nations in Central America. In the words of Moisés Naím:

> Reforming countries were discovering that economic growth did not matter much to people if hospitals did not have medicines, and that a booming stock market could be very dangerous if the domestic equivalent of the U.S. Securities and Exchange Commission were ineffectual. An exchange rate that made a country's products cheaper abroad was not enough to sustain an export-led strategy of economic growth if

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[220] Ropp and Morris, *Central America: Crisis and Adaptation*, 173.
[221] Ropp and Morris, 173–74.

> inefficiency and corruption paralyzed the ports, and fiscal reform mattered little if taxes could not be collected. The elimination of restrictions on foreign investment, while indispensable for attracting foreign capital, was from sufficient to make a country internationally competitive in the race to attract long-term foreign investment… In short, it became apparent that stronger, more effective institutions were urgently needed to complement macroeconomic policy changes. [222]

Institutional change does not occur overnight. Rather, with the passage of time and changing ways of thinking, institutions slowly evolve and transform. The political institutions, formal and informal, emerging out of colonial Costa Rica helped shape the current political institutions of the modern Costa Rican state, as institutions have continuity and longer lives than policies. Specifically, the development of the informal norm of compromise across social class has been essential to Costa Rican political development. Furthermore, the relative absence of political violence during the mid-19th century was crucial to creating a peaceful political arena, where compromise rather than political infighting was fostered. In Honduras, in contrast, an early concentration of economic and political power at the hands of the elites helped create an extensive network of corruption between the nation-state, political parties, and the country's elites. The early political and economic structures of the banana republic ruled by caudillos has certainly kept Honduras in a path of relatively little institutional change, thus limiting their chances at achieving economic development.

The political institutions of Costa Rica and Honduras have shaped the structure of their respective economies, influencing each nations' path toward economic development. As

[222] Naím, "Washington Consensus or Washington Confusion?," 93.

Washington Consensus policies were introduced into Costa Rica and Honduras, the policies interacted with the existing political institutions of each nation, creating different economic outcomes. In one hand, the inclusive political institutions of Costa Rica helped the nation achieve significant and sustained economic growth after the introduction of Washington Consensus reforms. In contrast, the extractive political institutions of Honduras prevented the reforms from achieving any material progress toward the country's development, as the vast network of corruption underlying the nation-state was still present and posed challenges to growth. It cannot be expected for economic policies to bring economic growth without there being a good institutional setting in which the reforms can take place.

The inclusive political institutions of Costa Rica allowed the country to attract significant Foreign Direct Investment (FDI) during the 1990s. Although inclusive political institutions had been the norm in Costa Rica since the 19th century, a more globalized world allowed foreigners to invest in the nation, as its economy opened up to foreign capital through the implementation of key reforms during the late 20th century. Corporations and foreign governments recognized the value of strong political institutions that protect property rights and enforced contracts. Foreigners' investments would be safeguarded by the political institutions of Costa Rica, as secure property rights and contract enforcement prevented the theft of investors' monies. One of the transformative FDI into the country was Intel's decision to open a $300 million microprocessors plant in 1998. The plant consisted of 400,000 square feet of manufacturing space, employing 2,000 people.[223] For Costa Rica to be considered a serious contender for Intel's plant, it had to prove positive economic conditions, an established and reliable political system,

[223] "Construction Begins On Intel's Costa Rica Assembly and Test Site," Intel Newsroom, April 24, 1997, https://newsroom.intel.com/news-releases/construction-begins-on-intels-costa-rica-assembly-and-test-site/#gs.0i07lt.

and a relatively transparent operating and legal environment.[224] The two final contenders for Intel's microchip plant were Costa Rica and Mexico, with Costa Rica ultimately winning the contract. Within the provisions of the contract, the government guaranteed Intel's registration in an authorized free trade zone, the awarding of a series of environmental and construction permits, and a government commitment to educational investments at several institutions for students studying electronics.[225] Ultimately, Intel's decision to invest in the country rested on four factors: the nation's political and social stability, a commitment to economic openness and liberalization, a focus on economic development in the electronics sector, and a receptive climate for foreign investment.[226] As seen, the strong political institutions of Costa Rica played a significant role in Intel's decision to invest significantly into the country. With Intel's investment, Costa Rica was able to develop a high-tech cluster where foreign companies were able to access tax incentives and cheap labor. Soon after, Microsoft, Infosys, and Hewlett Packard arrived in Costa Rica, further solidifying the nation's technology sector.

As a result of the intensive investments made into Costa Rica throughout the decade, particularly the one made by Intel, the nation was able to replace its main exports, coffee and bananas, with microchip and computer accessories.[227] By 2014, Intel's operation made up about 20% of Costa Rica's exports.[228] However, the Intel investment was not the only one present. Rather, Costa Rica engaged in negotiations with a number of technology companies, such as Microsoft, to obtain FDI.[229] As a result of corporations seeing Costa Rica as a peaceful and

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[224] Debora Spar, "Attracting High Technology Investment: Intel's Costa Rican Plant," Foreign Investment Advisory Service Occasional Paper (Washington, D.C: The World Bank, April 1998), 8–9, https://documents1.worldbank.org/curated/en/949541468770676701/pdf/multi0page.pdf.
[225] Spar, 11.
[226] Spar, 12.
[227] Hidalgo, "Growth without Poverty Reduction: The Case of Costa Rica," 1.
[228] "Intel Outside," *The Economist*, April 19, 2014, https://www.economist.com/the-americas/2014/04/19/intel-outside.
[229] Serge F. Kovaleski, "High Technology's Top Banana? Costa Rica Lures Intel, Other Industry Giants," *The*

democratic country with strong political institutions, the country saw a significant amount of FDI. The diversification of the country's exports was crucial to its economic development entering the 21st century. The influx of FDI into Costa Rica since 1990 can be seen in Table 1 below, relative to other Central American nations:

Central America: Selected Foreign Direct Investment Indicators, 1990-2010 (Millions of dollars and percentages)							
	1990-1999			2000-2010			
Country	Average amount (millions of dollars)	Percentage of GDP	Average Annual Growth Rate (%)	Average amount (millions of dollars)	Percentage of GDP	Average Annual Growth Rate (%)	Average Percentage Share
Costa Rica	351.3	3.1	109.7	1 161.8	4.1	116.1	21.9
El Salvador	143.7	1.2	21.9	459.5	2.6	107.5	6.2
Guatemala	150.4	1.0	117.0	540.2	1.9	114.2	9.3
Honduras	86.0	2.0	124.3	620.7	5.1	109.3	8.6
Nicaragua	93.3	2.8	53.1	376.4	6.9	112.4	5.4
Panama	481.7	5.2	116.5	1 410.6	6.8	114.6	24.4

Table 1
Source: Economic Commission for Latin America and the Caribbean (ECLAC)

The influx of FDI into Costa Rica can be compared to Honduras' FDI for the same period. During the 1990s, as seen above in Table 1, Costa Rica had an average $351.3 million FDI per year, meanwhile Honduras only averaged $86 million per year. It is interesting to note

Washington Post, March 11, 1998, https://www.washingtonpost.com/archive/business/1998/03/11/high-technologys-top-banana-costa-rica-lures-intel-other-industry-giants/bfb8eeda-eea0-4a3a-9f45-81f8c6101b92/.

that out of the Central American region, Honduras received the lowest average FDI amount per year, even considering the fact that Guatemala, El Salvador, and Nicaragua experienced continued civil conflicts the decade prior. Corporations and foreign investors simply did not feel safe investing in Honduras, as the vast networks of corruption underlying the nation-state, its institutions, and the country's elites prevented the creation of any return on capital. If a corporation decided to open a production plant in Honduras, there was no institutional guarantee that regulators and politicians would not request bribes in exchange for their needed approvals. There was no guarantee that foreign aid, intended for specific projects or structural reforms, will not be stolen by the country's elites or their associates. Simply put, investors did not trust the Honduran state to protect their capital nor guarantee positive returns.

From the FDI received throughout the 1990s, investments were made into the Costa Rican and Honduran economies. Investments were made across a number of economic activities and sectors, deeply shaping the countries' 21st century economies. From 1999 to 2011, Costa Rica dedicated a majority of its FDI into the manufacturing sector, averaging 50.6% of all FDI, followed by the services industry with 46.2%. Natural resources, including agriculture, only amounted for 3.2% of all FDI inflows into the country. During the same period, Honduras invested 49% of its FDI into the services sector, followed by the manufacturing sector with 40%. Natural resources, including agriculture, still amounted for a significant portion of FDI with 11%, as seen in Table 2. As seen, foreigners continued to invest a significant amounts of capital into the agricultural sector, continuing to deny the nation from much-needed economic diversification. It must also be said Costa Rica significantly invested more into the manufacturing sector, helping diversify its exports, raising the country's income with it.

Central America: Sectoral Distribution of Foreign Direct Investment, 1999-2011 (Percentages)						
Sector	**Costa Rica**	El Salvador	Guatemala	**Honduras**	Nicaragua	Panama
Natural Resources	3.2	1.5	19.1	11.0	5.1	0.0
Manufactures	50.6	20.9	26.2	40.0	24.6	8.1
Services	46.2	77.6	54.7	49.0	70.3	91.9

Table 2
Source: Economic Commission for Latin America and the Caribbean (ECLAC)

With foreign direct investment came a growth in both nations' exports. In 1990, Costa Rica was already the biggest exporter in Central America with nearly $1.5 billion in exports, not accounting for intraregional trade. Costa Rica was not the largest exporter within Central America, as it only exported exports valued at around $200 million while Guatemala's exports to other Central American markets were valued at around $321 million. In 1990, Honduras was one of the worst exporters in Central America, ranking second to worst in world trade, with exports valued at $554 million, and the worst in intraregional trade, amounting for $26 million in exports. However, Costa Rica's economic growth did not necessarily come from a growth in trade, as Honduras actually grew at a similar average annual rate than Costa Rica. From 1990 to 2011, Costa Rica averaged a 9.7% annual growth rate in world exports, while Honduras grew at around 9.2%. However, Honduras' exports to the Central American region increased significantly faster than Costa Rica's. Honduras achieved an average 17.4% annual growth in intraregional exports for the same time period, meanwhile Costa Rica averaged 12.3% annual growth. As seen in Table 3, both nations' export markets grew at a relatively similar rate, and at times, Honduras outperformed Costa Rica, especially in interregional trade.

Central America: World Exports and Intraregional Exports, 1990-2011 (Millions of dollars and percentages)						
	World			Intraregional		
Country	1990	2011	Average Annual Growth Rates	1990	2011	Average Annual Growth Rates
Costa Rica	1 455.6	10 222.2	9.7	200.6	2 297.0	12.3
El Salvador	409.1	4 065.1	11.6	136.1	2 061.5	13.8
Guatemala	1 163.0	10 161.0	10.9	321.3	3 176.7	11.5
Honduras	554.6	3 533.6	9.2	26.4	761.5	17.4
Nicaragua	340.0	3 892.7	12.3	47.9	504.2	11.9
Panama	340.8	14 554.8	19.6	45.1	2 543.8	21.2

Table 3
Source: Economic Commission for Latin America and the Caribbean (ECLAC)

What led to Costa Rica's success was a rise in the value of its exports, helping the country achieve significant economic growth for decades to come. Due to the influx of FDI into the country throughout the 1990s, significant achievements were reached in the economic diversification of the nation's exports, helping microchips become the country's top export by the end of the decade. The investments made by corporations, like Intel, were critical for the nation's economic success, as higher value exports were now produced within the country, helping its Gross Domestic Product to grow. Meanwhile, since not much economic diversification occurred in Honduras, bananas and coffee products remained its top exports, denying the country from achieving growth in the same manner as Costa Rica. Fast forward two decades later, Honduras' top exports are still mostly agricultural production, while Costa Rica's exports have shifted toward manufactures, as seen in Table 4 below.

Central America: Five Main Exports to the Rest of the World, 2011 (Percentages)					
Honduras	**Costa Rica**	Nicaragua	Panama	Guatemala	El Salvador
Coffee, including roasted and decaffeinated (35.9%)	Integrated circuits and electronic microstructures (18.5%)	Coffee, including roasted and decaffeinated (10.8%)	Antibiotics (24.4%)	Coffee, including roasted and decaffeinated (10.5%)	Coffee, including roasted and decaffeinated (11.4%)
Bananas or plantains, fresh or dried (5.5%)	Medical and surgical instruments and devices (8.2%)	Coaxial cables and other electric coaxial conductors (9.9%)	Medicaments (8.9%)	Minerals from precious metals and their concentrates (8.9%)	Jersey collar t-shirts, knitted or crocheted (5%)
Wires, cables (including coaxial cables) and other insulated conductors (4.8%)	Dates, figs, pineapples, avocados (7.1%)	Gold (including gold plated in platinum) (9.4%)	Other footwear with outer soles and uppers of rubber or plastic (4.1%)	Petroleum gas (6.4%)	Leg warmers, pantyhose, leotards, stockings, socks (4.9%)
Palm oil and derivatives (4.6%)	Bananas or plantains, fresh or dried (7.1%)	Meat of bovine animals, frozen (8%)	Perfumes and toilet waters (3.5%)	Cane or beet sugar (4.7%)	Cane or beet sugar (4.1%)
Petroleum gas and other gaseous hydrocarbons (4%)	Coffee, including roasted and decaffeinated (3.7%)	Tops, shirts and blouses for women or girls (6%)	Suits, coats, jackets, dresses, skirts (2.8%)	Bananas or plantains, fresh or dried (4.4%)	Petroleum or bituminous mineral oils (3.7%)
Total 54.8%	Total 44.6%	Total 44.1%	Total 43.7%	Total 34.9%	Total 29%

Table 4
Source: Economic Commission for Latin America and the Caribbean (ECLAC)

Since the 1990s, Costa Rica has been able to achieve significant and sustained economic growth as a result of its political institutions. The country's strong and inclusive political institutions have created a safe haven for foreign corporations to invest in the Central American region, as property rights and contracts are enforced. With institutional guarantees regarding the rule of law, Costa Rica experienced a vast influx of foreign direct investment starting in the 1990s, helping the country diversify and increase the value of its exports. The higher value and volume of exports helped Costa Rica achieve outlier status in the Central American region, as it is one of the region's largest economies and a beacon of continued democratic rule. Relative to Costa Rica, Honduras did not grow much during the 1990s. Foreign investors were discouraged by the country's lack of institutional guarantees as a result of its corrupted political and economic systems. Lacking the influx of FDI, Honduras failed to diversify its exports and to this day continues to primarily export agricultural commodities. Without diversification of its exports and a continued reliance on agricultural production, Honduras has not been able to achieve significant nor sustained economic growth. Applying a New Institutional Economics approach to Costa Rica and Honduras, it can be concluded that Costa Rica, because of its relatively robust political institutions, has been able to achieve sustained economic growth since 1990 relative to Honduras, where weak and corrupt institutions reign and pose significant challenges to growth.

China's Political Institutions: Autocracy and Political Development

China's impressive economic performance since the late 1990s poses a particular challenge to the theories pushed forward by New Institutional Economics. China, under authoritarian rule, has managed to transform from one of the poorest countries in the world into a major economic power today, becoming the world's second largest economy. Some might claim that China's economic prowess poses a formidable challenge against New Institutional

Economics, as an authoritarian nation has managed to grow significantly for the past couple of decades. However, it is important once again to make the distinction between democratic and political institutions. The claims made in this thesis pertain to political institutions, not democratic ones per se. While there is no clear separation between government and business in China,[230] it is wrong to claim that China has not developed strong political institutions since the Chinese Communist Party came to power. Although the nation has failed to democratize, strong political institutions have been developed, contributing to the impressive economic growth of the nation in the past couple of decades.

China's impressive economic growth depends on its institutions, primarily on what Xu refers to as the regionally decentralized authoritarian regime, which is a combination of political centralization at the hands of Beijing and economic regional decentralization in the hands of local governments. As a result, political power is heavily centralized and structured, which aids the national government in its pursuits of convincing regional leaders to follow the policies of the central government.[231] Under this regime, subnational governments maintain most of the power in the making of economic policy, as they have "influence or even direct control rights over a substantial amount of resources, such as land, firms, financial resources, energy, raw materials, and others." [232] From this decentralization of economic policy and high centralization of political power, China has been able to achieve a spectacular economic performance.

It is important to recognize how the decentralized authoritarian regime has helped China achieve significant economic growth. The central government links regional performance to an official's promotion, creating a tournament-like regional competition that fosters economic

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[230] Chenggang Xu, "The Fundamental Institutions of China's Reforms and Development," *Journal of Economic Literature* 49, no. 4 (December 2011): 1077.
[231] Xu, 1078.
[232] Xu, 1079.

growth and limits corruption, helping these officials implicitly create the political and economic institutions necessary for a functioning economy.[233] Therefore, although one political party, the Chinese Communist Party, controls pretty much all aspects of Chinese society, it is wrong to claim that China has not been able to create strong political institutions that have driven its vast and impressive economic growth.

In fact, China has engaged in a number of institutional changes in the past few decades in order to foster economic growth and pro-market reforms. In 2004, China introduced the constitutional protection of private property,[234] yet it must be recognized that China's impressive rise in the world economy was well underway by then.[235] The question then becomes: if China did not introduce meaningful institutional reforms which protect private property, how was it able to achieve its economic growth per New Institutional Economics? While it is true that formal and legal recognitions of private property did not occur in 2004, semiformal and informal protection of private property did exist in China before the 2004 reforms. Furthermore, contract enforcement did occur under some subnational governments and by social norms among the Chinese population.[236] Thus, the semiformal and informal institutions of the Chinese states acted as constraints on behavior in the early beginning of China's economic growth, helping propel the country to economic supremacy. As seen, not only do formal institutions help explain economic development, but rather informal and semiformal political institutions likewise seem to be a cause for economic development.

The lessons to be learned from China's impressive economic rise and its institutional context are many. First, New Institutional Economics should move away from referring to

[233] Xu, 1141.
[234] Xu, 1081.
[235] Zheng Bijan, "China's 'Peaceful Rise' to Great-Power Status," *Foreign Affairs* 84, no. 5 (2005): 18.
[236] Xu, "The Fundamental Institutions of China's Reforms and Development," 1081.

political institutions as a synonym for democracy. It has been proven extensively that economic growth can occur under autocracies, China being the primary example. Second, institutions need not necessarily be formal institutions. Existing institutions, formal or not, are deeply influenced by a country's history, social norms, culture, endowments, technologies, among other factors. Semiformal and informal institutions influenced by social norms are of extreme importance in the political and economic formation of a nation, as shown by China's experience. Lastly, China's institutions, particularly the regionally decentralized authoritarian regime, provide a solution that was crafted internally and works well for its people, showing that nations can engage in the creation and implementation of autonomous and country-specific economic policy without the supervision of the International Monetary Fund, the World Bank, the United States, or other first world organizations.

Political Institutions and Economic Development

Informal and formal political institutions have shaped the development paths of Costa Rica and Honduras. Starting out in the early 19th century, right after independence, Costa Rica was able to create informal inclusive political institutions, such as the norm of elite consensus rather than elite infighting. Since the introduction of coffee for commercial purposes, the Costa Rican elite have engaged in building stronger political institutions in pursuit of economic returns. Due to scarce labor, landless agricultural workers demanded higher wages from wealthy and landed coffee producers, thus creating yet another informal inclusive political institution, formalizing the norm of bargaining across social classes. From these early developments, Costa Rica engaged in the creation of an egalitarian identity, where citizens felt represented by the system and were not discouraged from seeking change. These informal political institutions predate the establishment of Costa Rican democracy, signaling that robust political institutions do not necessarily have to mean democracy. Rather, these early political institutions helped craft a Costa Rican political identity that transcended into the 20th century, showing the continuity and adaptation of political institutions through time.

The Costa Rican political institutions of the 19th century deeply influenced the political institutions of the 20th century. The Costa Rican egalitarian political identity fostered in the 19th century clearly influenced administrations that sought to increase the role of the nation-state in the economy during the following century. During the mid-20th century, the Costa Rican state made massive investments into the economy, signaling that unfettered capitalism could not continue without providing for the general welfare of the population. Throughout the century, the country engaged in the active expansion of democracy for all, solidifying its inclusive political institutions. It is exactly under this relatively strong institutional setting that Washington Consensus policies began to be implemented in Costa Rica. Because of the nation's inclusive political institutions, economic growth was able to occur after the introduction of Washington Consensus policies. If it were not for the nation's robust and inclusive political institutions, the reforms would likely have failed, as they did in Honduras.

For most of its history, Honduras has engaged in the protection of the elites' economic interests. Since the introduction of bananas to the country and the consolidation of political and economic power into the hands of a few during the 1840s, the Honduran state has not sufficiently provided for the vast majority of its population. As a result of the concentration of wealth in the hands of a select few, the Honduran state adopted extractive political institutions, meant to protect the material wealth of the country's elites. Through the creation of extractive political institutions during the 19th century, where only the interests of the elites were protected, Honduras' institutional journey has not changed much. Rather, the nation's institutional path has only solidified and formalized the institutions born 150 years ago. Because of the lack of political voice for the landless in the early creation of the Honduran state, to this day, Honduran democracy continues to be fragile. Taking in the developments of the 20th century, especially military rule, the state helped in the creation of a vast corruption network between the nation-state, its political institutions, and the country's elites. As seen, not much changed in the 20th century for Honduran institutions. They continued being extractive political institutions where elite interests were centered, and the general welfare was not considered.

It cannot be expected for Washington Consensus policies to provide magical solutions that fixed the extractive nature of the Honduran state. Rather, it must be emphasized that even if the Washington Consensus policies were implemented, which they were, the country's political institutions, deeply rotten by decades-long corruption, likely worked against the policies. Development monies would still be funneled into the elites' private estates, government officials were still being bribed by the wealthy, and the country was simply unable to achieve growth under these circumstances. As a result of the vast faults present within the nation-state, Honduras will not achieve sustained economic growth until it begins to fix its extractive political institutions. If the country truly desires to achieve economic growth, it must take concrete steps to dismantle the network of corruption underlying the nation-state, its political institutions, and the country's elites. Furthermore, political and economic reforms must be enacted to bring the nation's poor into the political arena, as their voices are critical in the economic development of any nation.

The political institutions of Costa Rica and Honduras have clearly shaped their respective development paths. On one hand, the inclusive political institutions of Costa Rica, fostered since the establishment of the Republic, have played a massive role in the country's economic development once Washington Consensus policies were implemented in the late 20th century. The inclusive institutional setting in Costa Rica allowed the Washington Consensus policies to truly take effect, achieving the promises made to Latin American nations after the Lost Decade. In contrast, Honduras' extractive institutional setting prevented economic development to take off in the latter part of the 20th century. Rather, the Washington Consensus reforms implemented in Honduras did not manage to help the country overcome its profound economic issues. The combination of institutional settings and the introduction of the Washington Consensus policies deeply influenced the development paths of Costa Rica and Honduras. With Washington Consensus policies acting as a catalyst, the influence of political institutions on economic development were clearly demonstrated in the economic divergence of 1990 between both Central American nations.

Data and Econometrics Complement

Data

In seeking to assess the relationship between political institutions and economic development, I chose *GDP (current US$)* as the economic indicator of the model, as well as the dependent variable since it provides a concise and applicable measure of a country's economic activity. From the World Bank database, *GDP (current US$)* data was obtained from years 1960 to 2020 for Honduras and Costa Rica. In total, the data set has 120 *GDP (current US$)* observations, encompassing 6 decades.[237] World Bank data was chosen because the multilateral organization often provides financing to both countries, therefore its economic data must be valid, accurate, and up to date. Thus, the World Bank's GDP data set provides crucial data for my model, as it informs my dependent variable.

To explain the divergence in incomes between Costa Rica and Honduras, I am pursuing a New Institutional Economics approach to consider the impact a country's institutions have in economic development. I define a country's institutions solely in the political space, encompassing a country's governmental institutions, state of fundamental rights, checks on government, impartial governance, and the participatory engagement of its population. While other institutions surely exist within a nation-state, it is important for purposes of this paper to focus on a country's political institutions, as it guides the political and economic structures of a society and thus, economic development.

Institutional strength data was obtained from the International Institute for Democracy and Electoral Assistance (IDEA), an intergovernmental organization which seeks to support and strengthen democracy and electoral processes around the world. The data set used for this thesis

[237] "GDP (Current US$) - Costa Rica, Honduras."

is IDEA's Global State of Democracy Index, which depicts countries' democratic trends at a national, regional, and global level from 1975 to 2020. In total, the data set has 20 variables, and all variables have a total of 92 observations, 46 observations for Costa Rica and 46 observations for Honduras, except for two variables which have 91 observations. The 20 variables in the data set are: *representative government, fundamental rights, checks on government, impartial administration, clean elections, inclusive suffrage, free political parties, elected government, access to justice, civil liberties, social rights and equality, effective parliament, judicial independence, media integrity, absence of corruption, predictable enforcement, civil society participation, electoral participation, direct democracy, and local democracy*.

All variables are scored from zero to one, one being a perfect score in what the respective variable is measuring, and zero representing a complete absence of such variable. The data provided by IDEA ranges, for both Costa Rica and Honduras, from 1975 to 2020.[238] Thus, the encompassing nature of the data will provide a good foundation to build a model to study the relationship between political institutions and economic development. The IDEA data set was chosen for use as it comes from an intergovernmental organization dedicated to the study of democracy and electoral processes. In finding data sets dealing with democratic indexes, it is crucial to only use data sets that do not show biased or manipulated data, but rather have a neutral approach to gathering its data. Thus, the IDEA data set was chosen, as it fits the criteria aforementioned and likewise has data spanning more than four decades.

Summary statistics are provided in Table 5 for all explanatory variables and dependent variable in the data set.

[238] "The Global State of Democracy Indices" (International Institute for Democracy and Electoral Assitance, 2021), https://www.idea.int/gsod-indices/democracy-indices.

Costa Rica, Honduras State of Democracy Summary Statistics					
	N	Mean	SD	Min	Max
Log GDP	92	22.986	0.971	20.840	24.881
Representative Government	92	0.718	0.230	0	0.971
Fundamental Rights	92	0.621	0.191	0.333	0.869
Checks on Government	91	0.626	0.179	0.282	0.836
Impartial Administration	92	0.486	0.186	0.238	0.695
Clean Elections	92	0.717	0.238	0.002	0.958
Inclusive Suffrage	92	0.891	0.219	0	0.980
Free Political Parties	92	0.715	0.182	0.315	1
Elected Government	92	0.884	0.243	0	1
Access to Justice	92	0.608	0.199	0.351	0.875
Civil Liberties	92	0.768	0.153	0.422	0.947
Social Rights and Equality	92	0.487	0.170	0.169	0.734
Effective Parliament	91	0.559	0.243	0.063	0.868
Judicial Independence	92	0.591	0.156	0.294	0.760
Media Integrity	92	0.729	0.129	0.519	0.894
Absence of Corruption	92	0.450	0.191	0.225	0.657
Predictable Enforcement	92	0.552	0.178	0.269	0.766
Civil Society Participation	92	0.600	0.132	0.354	0.743
Electoral Participation	92	0.662	0.179	0	0.851
Direct Democracy	92	0.048	0.096	0	0.311
Local Democracy	92	0.714	0.226	0.375	0.951

Table 5: Summary Statistics

Econometrics Model

To assess the relationship between political institutions and economic growth, a Multiple Linear Regression (MLR) Analysis was performed. However, not all explanatory variables from the IDEA data set were included in the regression models, as including all 20 explanatory variables will lead to issues with multicollinearity. For the model's dependent variable, the Gross Domestic Product (GDP) variable from the World Bank will be used to assess economic growth. However, the dependent variable was transformed to be in the form of log(GDP). In the regression, using log(GDP) allows for the interpretation to be in percentage changes, allowing better interpretations. From the IDEA data set, nine explanatory variables will be used to assess the relationship between political institutions and economic growth. The nine explanatory variables of the model are: *Checks on Government, Clean Elections, Free Political Parties, Social Rights and Equality, Effective Parliament, Judicial Independence, Absence of Corruption, Civil Society Participation, and Electoral Participation.* These variables vary with time for both Costa Rica and Honduras. For example, the score for Clean Elections in Honduras in 1980 is expected to be different from the score for Clean Elections in 2000 for the same country. Finally, Year Fixed Effects were added to the model because panel data is used, and year effects are important to capture in the model. Ultimately, the MLR model is:

$$\text{Log(GDP)} = \beta_0 + \beta_1(\text{ChecksOnGovernment}) + \beta_2(\text{CleanElections}) + \beta_3(\text{FreePoliticalParties}) + \beta_4(\text{SocialRightsandEquality}) + \beta_5(\text{EffectiveParliament}) + \beta_6(\text{JudicialIndependence}) + \beta_7(\text{AbsenceofCorruption}) + \beta_8(\text{CivilSocietyParticipation}) + \beta_9(\text{ElectoralParticipation}) + \delta(\text{i.year}) + u$$

The model thus will be able to assess the relationship between political institutions and economic growth. All the explanatory variables are tracking the performance of both Costa Rica and Honduras in the respective political institution or political trait the variable is measuring, for example, the variable *clean elections* assesses how clean presidential and local elections are in Costa Rica and Honduras. Therefore, the model will provide a good assessment of the role political institutions play in economic development and the growth of income.

I expect all explanatory variables in the model to be statistically significant. Furthermore, I expect *Checks on Government, Clean Elections, Free Political Parties, Social Rights and Equality, Effective Parliament, Judicial Independence, Civil Society Participation,* and *Electoral Participation* to have positive coefficients, meaning that there is a positive relationship between these explanatory variables and Gross Domestic Product, granted the respective variable is statistically significant. In contrast, I expect the variable *Absence of Corruption* to have a negative coefficient in the model, as the variable is tracking an *absence* of corruption, rather than corruption itself. This means that a country with a higher *Absence of Corruption* score is less ridden with corruption.

Therefore, the model built from the data sets will be able to assess the relationship between political institutions and economic development. One notable thing to note, however, is that my model does not control for geography or market integration, the two other possible economic growth theories. The reason for the exclusion of those controls is that for geography, there exists a debate on how exactly to measure the effect of geography on economic growth. For example, some theorists measure geography as a distance from the Equator, while others use the distance from a country's largest trading partner. The exclusion of integration is due to the fact that both Costa Rica and Honduras are subject to CAFTA-DR, and both countries have preferential treatment, most favored nation status, under World Trade Organization rules. Therefore, my model does not include these controls as no more ambiguity over the measurement of variables or unnecessary variables are desired.

Results and Discussion

Without the inclusion of Year Fixed Effects, the explanatory variables in the model (which track the strength of political institutions) do provide some explanation for economic growth. Specifically, all explanatory variables in the model without Year Fixed Effects are statistically significant except for variable *Judicial Independence,* as seen in Figure 4. Therefore, from the results of the regression, there is an expected positive effect on Gross Domestic Product when a country's political institutions are stronger, *ceteris paribus.*

For example, a one unit increase in *Effective Parliament* in the model without Year Fixed Effects is expected to lead to a 906% increase in Gross Domestic Product, as seen in Figure 4. However, it must be noted that a one unit increase in any of the explanatory variables is nearly impossible to attain, due to IDEA's data collection methods. All explanatory variables are measured from zero to one, thus a one-unit increase would mean a country would go from a complete absence of a variable to a perfect score. Specifically, a zero score in *Effective Parliament* would mean a country's legislature is ineffective, ridden with corruption and under the control of one political party, producing no real policy for the respective country, much like a failed state. To obtain a 906% increase in Gross Domestic Product, the country would have to completely revamp its legislature and become a fully functioning democracy, which is extremely difficult task to achieve. Therefore, because there are very few countries in the data set that have zero scores in any explanatory variables, and a one-unit increase is not attainable in a short amount of time, the regression results and the interpretation of OLS coefficients should be taken as a recommendation rather than definite policy. However, the insights provided by the regression results and OLS coefficients do reinforce the narrative that political institutions are important for economic development, as countries with stronger political institutions tend to experience higher Gross Domestic Products. Given that the results from the MLR model are based on Costa Rican and Honduran data, it can be stated that political institutions do have an expected effect economic development. Stronger and more robust institutions, like those in Costa Rica, aid the nation in the implementation of economic policy, unlike in Honduras, where the weak and corrupt nation-state prevents political institutions from acting as constraints. Costa Rica has been able to grow significantly after 1990 due to its strong inclusive political institutions, and Honduras has remained stagnant due to its weak extractive political institutions. Moving forward, it is imperative for Honduras to strengthen its political institutions if it wishes to obtain sustained economic growth.

Source	SS	df	MS	Number of Obs	=	91
Model	**81.821**	**9**	**9.091**	F (9, 81)	=	**233.78**
Residual	**3.149**	**81**	**0.039**	Prob > F	=	**0**
Total	**84.971**	**90**	**0.944**	R-squared	=	**0.9629**
				Adj R-squared	=	**0.9588**
				Root MSE	=	**0.1972**
log GDP	Coefficient	Std. Error	t	P > |t|	[95% conf. interval]	
Checks on Government	**-9.881**	**4.135**	**-2.39**	**0.019**	**-18.109**	**-1.653**
Clean Elections	**-0.858**	**0.374**	**-2.29**	**0.024**	**-1.603**	**-0.113**
Free Political Parties	**2.924**	**0.719**	**4.06**	**0**	**1.492**	**4.356**
Social Rights and Equality	**7.624**	**0.786**	**9.7**	**0**	**6.061**	**9.187**
Effective Parliament	**9.062**	**1.365**	**6.63**	**0**	**6.344**	**11.779**
Judicial Independence	**-2.287**	**2.062**	**-1.11**	**0.271**	**-6.389**	**1.816**
Absence of Corruption	**-2.828**	**1.182**	**-2.39**	**0.019**	**-5.181**	**-0.476**
Civil Society Participation	**-4.361**	**1.041**	**-4.19**	**0**	**-6.432**	**-2.289**
Electoral Participation	**-1.533**	**0.308**	**-4.98**	**0**	**-2.145**	**-0.921**

Table 6: MLR Without Year Fixed Effects

The first model in the MLR analysis supports my theory that institutions, specifically political institutions, played a significant role in Costa Rica's impressive economic growth after 1990. As a result of its stronger political institutions, Costa Rica has been able to grow stronger economically, relative to Honduras, which has remained stagnant due to its poor political institutions. History agrees with the results reached by this analysis. Costa Rica has been able to maintain continuous democratic rule since 1949.[239] In contrast, Honduras has been subject to political instability for most of its history, most recently concluding with the 2009 Honduran coup d'état and the United States accusing current Honduran President Juan Orlando Hernandez with narcotrafficking charges.[240] [241] As seen, the history of economic divergence between Costa Rica and Honduras seems not only to be a divergence in economic performance, but also a divergence in political institutions and democracy overall.

The second model of the MLR analysis includes Year Fixed Effects, as it is important to assess for the effect years have on economic performance over time, as well because of the use of panel data in the model. It is interesting to note that the results from the second model differ from the results obtained in model 1, all due to the inclusion of Year Fixed Effects. In the second model, only three explanatory variables, *Social Rights and Equality, Effective Parliament*, and *Civil Society Participation* are statistically significant, as seen in Figure 5. Furthermore, the OLS coefficients change significantly. For example, a one unit increase in *Effective Parliament* only leads to a 479% increase in Gross Domestic Product, as compared to a 906% increase in Gross Domestic Product in the model without Year Fixed Effects.

Source	SS	df	MS	Number of Obs	=	**91**
Model	**84.163**	**54**	**1.559**	F (9, 81)	=	**69.52**
Residual	**0.807**	**36**	**0.022**	Prob > F	=	**0**
Total	**84.971**	**90**	**0.944**	R-squared	=	**0.9905**
				Adj R-squared	=	**0.976**
				Root MSE	=	**0.149**

[239] Sada, "The Curious Case of Costa Rica: Can an Outlier Sustain Its Success?," 11.
[240] Elisabeth Malkin, "Honduran President Is Ousted in Coup," *New York Times*, 2009, https://www.nytimes.com/2009/06/29/world/americas/29honduras.html.
[241] Will Grant, "Has Honduras Become a 'Narco-State'?," *BBC News*, 2021, https://www.bbc.com/news/world-latin-america-56947595.

log GDP	Coefficient	Std. Error	t	P > |t|	[95% conf. interval]	
Checks on Government	**-3.111**	**5.339**	**-0.58**	**0.564**	**-13.939**	**7.718**
Clean Elections	**0.29**	**0.695**	**0.42**	**0.679**	**-1.119**	**1.699**
Free Political Parties	**-1.221**	**1.084**	**-1.13**	**0.267**	**-3.419**	**0.977**
Social Rights and Equality	**8.421**	**2.392**	**3.52**	**0.001**	**3.569**	**13.273**
Effective Parliament	**4.798**	**1.531**	**3.13**	**0.003**	**1.694**	**7.903**
Judicial Independence	**-1.617**	**2.555**	**-0.63**	**0.531**	**-6.799**	**3.566**
Absence of Corruption	**-3.993**	**2.968**	**-1.35**	**0.187**	**-10.015**	**2.027**
Civil Society Participation	**-2.759**	**1.228**	**-2.25**	**0.031**	**-5.249**	**-0.269**
Electoral Participation	**-0.611**	**0.556**	**-1.1**	**0.279**	**-1.739**	**0.517**

Table 7: MLR With Year Fixed Effects

Ultimately, the inclusion of Year Fixed Effects, while it does change the model, continues supporting my theory that political institutions provide an explanation for Costa Rica's impressive economic growth relative to Honduras. The Year Fixed Effects of the second MLR must be explored a little bit more in depth. The inclusion of the Year Fixed Effects takes away some of the statistical significance of some explanatory variables in the model, as we have seen. However, that does not mean political institutions do not explain economic growth. Rather, since the dependent variable of the model is log(GDP), which tracks Gross Domestic Product, it is not surprising that the Year Fixed Effects remove some of the statistical significance of some explanatory variables. It is expected that Gross Domestic Product grows over time, meaning that the passage of time, represented by the Year Fixed Effects, is likewise expected to hold some statistical significance. Nonetheless, the significance of Year Fixed Effects should not deviate from the story of political institutions and economic development, as the model suggests that institutional strength does drive economic growth, as seen in Figure 6.

Output Table		
Dependent Variable: Log GDP		
	(1)	(2)
Checks on Government	**-9.881***	**-3.111**
	(-2.39)	**(-0.58)**
Clean Elections	**-0.858***	**0.290**
	(-2.29)	**-0.420**
Free Political Parties	**2.924*** **	**-1.221**
	-4.060	**(-1.13)**
Social Rights and Equality	**7.624*** **	**8.421** **
	-9.700	**-3.520**
Effective Parliament	**9.062*** **	**4.798** **
	-6.630	**-3.130**
Judicial Independence	**-2.287**	**-1.617**
	(-1.11)	**(-0.63)**
Absence of Corruption	**-2.828***	**-3.994**
	(-2.39)	**(-1.35)**
Civil Society Participation	**-4.361*** **	**-2.759***
	(-4.19)	**(-2.25)**
Electoral Participation	**-1.533*** **	**-0.611**
	(-4.98)	**(-1.10)**

Table 8: Output Table

Insights from the Model

Costa Rica and Honduras, two small countries in Central America, provide some insights into the growing field of New Institutional Economics. Costa Rica, because of its strong political institutions, highlighted by its continued democratic rule since 1949, has experienced significant economic growth since 1990. In contrast, Honduras, a country plagued with sociopolitical crises, most recently by the 2009 coup d’état and narcotrafficking accusations against its former President, has remained economically stagnant for most of its modern history. Considering that both countries have similar colonial histories, as both were colonized by the Spanish and declared independence together, and have similar geographies and trade histories, alternative theories explaining their economic differences must be provided.

The Multiple Linear Regression Analysis conducted concludes that institutions indeed to explain Costa Rican and Honduran economic development from 1975 to 2020. In the first regression model without Year Fixed Effects, all explanatory variables, except for one, are statistically significant and have expected positive effects on Gross Domestic Product. However, with the inclusion of Year Fixed Effects, only three explanatory variables are statistically significant. It is crucial to note that since the dependent variable of the model is Gross Domestic Product, the passage of time, through the inclusion of the Year Fixed Effects, is to be expected to have some statistical significance as GDPs are expected to keep growing yearly. Nonetheless, the results of the second model should not deviate from the narrative that the political institutions of Costa Rica have allowed the country to become an economic outlier in the region, outperforming every other Central American nation for the past 30 years.

Another important aspect to consider is that the MLR model solely explores the relationship between formal political institutions and economic performance. As explained before, North argued that political institutions do not necessarily have to be formalized and defined institutions, as institutions can be informal norms or behaviors rather than an established organization. With this in mind, it is imperative to note that informal political institutions, such as norms and behaviors, are not included in the MLR model. The relationship between informal political institutions and economic growth is thus not assessed. However, through the theoretical framework still stands, as informal political institutions, like norms of behavior, have clearly influenced the formal political institutions of Costa Rica and Honduras. Thus, while informal political institutions are not assessed by the MLR model, they should not be forgotten, as they affect the political and economic behaviors of heads of states, elites, and common citizens.

The results of the case study conducted in this paper provide some considerations for countries around the world to consider. As seen, political institutions do indeed play a role in economic development and growth. Therefore, if a country wants to grow sustainably in the long term, it should invest in its political institutions. Now that countries are starting to look for alternatives to the neoliberal blueprint provided by the Washington Consensus and its advocates, political institutions can guide the way forward for countries to achieve growth. However, that is not to say that challenges do not lie ahead. Honduras, for example, is still controlled politically by a small circle of elites who only have their own rent-seeking interests in mind. It will take political willingness and courage to stand up against the political elite, yet the rewards of strengthening political institutions should serve as an incentive to move forward.

Conclusion

New Institutional Economics provides an explanation for the impressive economic growth undertaken in Costa Rica in 1990. Through the theoretical framework provided in Chapter 4, which builds on the contributions from North, as well as Acemoglu and Robinson, it is clear that the inclusive political institutions of Costa Rica have helped the country grow economically, achieving outlier status in the Central American region. From the econometrics component from Chapter 5, the Multiple Linear Regression Model concludes that political institutions do drive economic growth in Costa Rica and Honduras. Considering that the economic divergence between Costa Rica and Honduras occurred in 1990, it can be asserted that the institutional setting of the respective country shaped its economic development outcome.

Institutions, like economic outcomes, are path dependent. In Central America, the political institutions of the 19th century deeply influenced the institutions of the 20th century, setting the institutional setting on a path dependency where the institutions of the present are dependent on the institutions of the past. The inclusive political institutions of Costa Rica, born after the introduction of coffee for commercial purposes in the 1840s, have shaped the nation's economic outcomes. The development of relatively egalitarian political institutions brought forward a distribution of material wealth among the country's population, as landless agricultural workers demanded high wages for their labor. While these informal political institutions are not responsible for the massive 1990 economic takeoff, they established the foundations for the political institutions of the 20th century, which provided an appropriate institutional setting where Washington Consensus policies were introduced. In Honduras, egalitarian political institutions simply did not develop. Rather, with the introduction of banana production, the nation-state sought to protect the interests of the elites, militarizing for the protection and promotion of mass banana production.[242] As seen, rather than taking into consideration the needs of the overall population, Honduras centered elite interests for most, if not all, of its history. Because of this early institutional setting during the mid-19th century, Honduras created extractive political institutions where only a select few could win. The nation's 19th century institutions likewise influenced the country's 20th century institutions, specifically in a continuation of their extractive nature. During the 20th century, the nation-state became entrenched in a network of corruption underlying the government, political institutions, and the country's elites. This network of corruption has prevented economic growth from occurring, as development monies are funneled into private estates rather than allocated toward areas of high economic return.

The institutional settings in which Costa Rica and Honduras found themselves in the late 20th century are of extreme importance in explaining the 1990 economic divergence. Economic reforms, such as the Washington Consensus, cannot be expected to succeed without good institutional frameworks in which nations can ensure adherence to the rule of law and economic outcomes that do not solely benefit a select few. The institutional divergence between Costa Ric and Honduras is at the root of their economic divergence. Through the development of relatively egalitarian inclusive political institutions, deeply rooted in the nation's history, Costa Rica achieved significant economic growth after 1990, as it enjoyed massive economic growth alongside a more interconnected and globalized world. Meanwhile, Honduras, due to its poor extractive political institutions has not been able to enjoy the benefits of economic liberalization. If Honduras wishes to attain strong and sustained economic development, it must take concrete steps to deconstruct its network of corruption, as well as bringing in a representative sample of the population into the political process.

[242] Lehoucq, *The Politics of Modern Central America: Civil War, Democratization, and Underdevelopment*, 19.

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