

2020 FOCUS BRIEF on the World's Poor and Hungry People

October 2007

ECONOMIC REFORM TO STIMULATE GROWTH AND REDUCE POVERTY The Latin American Experience

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A few decades ago a dominant view in the developing world was that growth problems in developing countries could be best understood in terms of the international environment. Today, no one seriously questions the influence of external conditions on growth. But most economists would also emphasize structural conditions within developing countries as key determinants of the large differences in the rates of per capita income growth among such countries. An examination of the economywide policy reforms that took place in Latin America and the Caribbean (LAC) during the 1980s and 1990s is particularly relevant to an understanding of these determinants. Though it is beyond the scope of this brief to discuss economic growth theories and assess the successes and failures of the economic reforms in the region, the discussion will focus on some of the significant linkages between growth, policy, and poverty.

Overview of Latin American Economic Policy Reforms since the 1980s

Economic regimes in Latin America started to change during the 1980s. The results of previous import-substitution strategies bred disillusionment and a general acceptance of theoretical developments regarding the causes of inflation and macroeconomic disequilibrium. In most countries in the region, a macroeconomic framework designed for open economies began to replace the prevailing closed-economy approach. Governments introduced economywide reforms emphasizing macroeconomic stabilization, deregulation, unilateral trade liberalization, and privatization. Economists generally concur that the impetus for the reforms arose from concerns regarding economic strategies affecting all sectors, not any one sector in particular. Nonetheless, in several countries, certain import-competing subsectors did retain special status in economic policymaking.

Several countries introduced reforms amid major macroeconomic disequilibrium characterized by high inflation and unsustainable fiscal and current account deficits. In many cases, the options for macroeconomic reform were quite limited; for decades, several LAC countries suffered from high rates of inflation and recurrent

external crises (balance of payments problems, foreign debt crises). Such macroeconomic instability substantially reduced growth rates and worsened income distribution. The poor, who lacked the wherewithal to shield the value of their assets and also suffered from real wage declines, were particularly harmed. The two main causes of inflation were large fiscal deficits, frequently financed by printing more money, and the mistaken notion that economies could buy prosperity with a little more inflation.

Beyond dealing with the severe macroeconomic disequilibrium, the goal of many reformers in the mid-1980s and early 1990s was to create a better climate for productivity and private investment in all economic sectors, including one very important for many of the poor—agriculture. For the farm sector, the result was to be an enhanced competitiveness of the tradable sectors in a new scenario in which agriculture was to be substantially more integrated with the world economy.

Of course, the reforms most immediately affected the incentives facing producers through changes in the prices of tradable goods as the result of the liberalization of trade policy. In most Latin American countries, the major change in trade policy was the partial or total removal of most quantitative restrictions on imports and exports, the elimination of export taxes, and a gradual reduction in the levels of import tariffs. This created incentives to move resources from import-competing goods toward the export-oriented and nontraded sectors. In most countries, importable goods were protected and exportable goods were taxed. A central goal of the reforms was to reduce the explicit and implicit anti-export bias that had existed previously—especially for agriculture, which had been burdened as a producer of wage goods and fiscal revenue and as a major employer of unskilled labor.

Perhaps more important for all sectors, but especially for agriculture, were the indirect effects on exchange rates and interest rates—two key prices to which the sector is particularly sensitive. By the mid-1990s, the exchange rate was recognized as the most important “price” affecting

the import-competing and export-oriented economy. This was not well understood at the time of the reforms, or at least it was not anticipated to be a future problem. Academicians expected that one result of trade liberalization and the reduction of the fiscal deficit would be a depreciation of the real exchange rate. What they did not anticipate was the significant appreciation of the currency associated with the opening of the capital account, the interest of foreign investors attracted to the promise of growing economies, or the significant increase in domestic real interest rates induced by macroeconomic conditions.

The depth and impact of the reform process within the LAC region has been quite diverse; it has also been the subject of various studies. But it is important to note the unilateral nature of trade liberalization in the region during the late 1980s, predating the Uruguay Round agreement of the World Trade Organization (WTO). Many LAC countries were members of the General Agreement on Tariffs and Trade (GATT), and those that were not joined the WTO at the time of the Uruguay Round negotiations. LAC emerged from the Uruguay Round without obligations to significantly reform trade policy.

Reforms—and often the lack of reforms—in the service sector also played a critical role in determining outcomes. It is important to note that deregulation and privatization had a major impact on the availability of more reliable and lower cost services to the economy as a whole. And these reforms in the domestic sector also complemented trade-related reforms. Examples include the privatization and deregulation of port facilities in Argentina, Colombia, Mexico, and Chile. Chile also initiated reforms in telecommunications and airline and shipping transport services that were soon adopted by most other countries. These apparently ancillary reforms were at the center of a new environment for trade-oriented producers and investors.

The Importance of Policy for Stimulating Poverty-Reducing Growth

A large body of recent economic literature focuses on the relationships between growth and poverty reduction. Dollar and Kraay's controversial study, *Growth Is Good for the Poor*, documented the empirical regularity of the link between growth and poverty using panel data from 92 countries over four decades and provoked wide debate by concluding that, on average, the mean income of a country's poorest quintile rises and falls at the same rate as average national income. Moreover, the study found that other policy-related factors, such as public expenditures on health and education, and improvements in labor productivity in agriculture had little marginal effect on the average income of the poorest.

The controversies sparked by these findings have raised questions regarding the role of

inequality in determining the importance of growth for the poor, and the impact of education on poverty. For example, simple pro-growth strategies to reduce poverty could raise the incomes of the poor, but could more rapidly increase the incomes of the nonpoor, thereby exacerbating income disparities. Another study noted that although overall growth reduces the poverty rate, the degree to which the poor share in the growth varies widely across countries. It found that the ability of the poor to enjoy the benefits of growth is particularly sensitive to the initial conditions of a country's economy—especially to the degree of income inequality.

Additional research finds that improved educational outcomes should be a component of a "super pro-poor" strategy to both raise the incomes of the poor and lessen income disparities. This cross-country growth perspective is highly consistent with the literature on household survey analyses, where broad consensus holds that education is important for raising the incomes of poor households. The analyses almost always show increasing returns to education, though the returns are, of course, influenced by education quality, parents' schooling, and other variables. Importantly for the rural poor, the returns to education also depend on where and how that education is applied. In Latin America, the returns to schooling are higher in urban areas than in rural areas, and higher for nonfarm activities than for farm-related ones.

Despite the controversies surrounding the impact of growth on poverty and the importance of other variables such as education, there is no question regarding the direction of the impact of growth on poverty overall. Even in a scenario with high income inequality (which is often the case in middle-income countries, of which Latin America has many), the average income of households in the poorest quintile would still increase, although at a lower rate than average national income. Where there is lower inequality, the average income of the poorest would increase even more. Moreover, higher growth rates that lead to higher incomes across all households indirectly support government revenues, and, in turn, allow for higher levels of spending on social programs. Hence, economic growth has a complementary role in sustaining social policies.

Research has indicated that policies affect average income growth, that average income growth affects poverty, and that income distribution affects the influence of growth on poverty. But it is not clear how policy affects income distribution and how income distribution affects growth. One difficult question is whether or not a conflict exists between policies that affect distributional measures and poverty in the short term, and policies that foster growth and poverty alleviation in the long term. Of course, there may be policies that both reduce income disparities

and spur economic growth, such as enabling poor households to accumulate assets, improving access to education, and undertaking measures such as safety nets to sustain households in the event of adverse income shocks. Evidence strongly indicates that sustained growth continues to be a necessary condition for reducing poverty. The lesson that emerges from the literature is that economic growth can be more pro-poor in some circumstances and less in others, and that less inequality is better than more. But by itself, growth is pro-poor. Several studies have shown that the patterns of growth matter because some industries depend more on unskilled labor than others.

Policies that are biased against labor-intensive sectors work to the detriment of the poor. While certain policies do contribute to growth and reduce income disparities—such as education—other policies involve trade-offs. As documented in the growth literature generally and in studies on Latin America in particular, three broad policy-related concerns have immediate impacts on growth, but not necessarily on income distribution: financial deepening, trade liberalization, and limitations on the size of government. Opening the financial system and the economy, reducing government interventions and spending (often forced by fiscal deficits), and stimulating growth could result in greater opportunities for those with more human and physical assets. Although the incomes of the poor could rise, the incomes of the skilled labor force and the returns on capital could rise much faster. Before treasuries can enjoy the longer term benefits of economic growth, the very fiscal constraints that might have spurred reforms—coupled with institutional weaknesses—limit governments' ability to mitigate inequities via subsidies and transfers, and as a result exacerbate income inequalities. Eventually, however, governments can afford to focus on equity concerns and public goods. Then the question becomes one of the effectiveness of public spending (see Box 1 for an overview of the composition of public expenditure in Latin America).

Beyond these broad growth-stimulating policies, more specific policies can capitalize on synergies and, as a consequence, achieve a balance between generally enhancing growth and increasing the incomes of poor people. For example, investments in infrastructure development not only provide a boost to economic activity, but also provide poorer households with greater access to educational opportunities. Conditional cash transfers are another example; they directly raise the incomes of the poor and improve the health and education of children, which has dynamic effects for future income generation. A third example is the reduction of

Box 1—The Composition of Public Expenditures in Latin America

Many studies on rural development present a rich agenda for policy initiatives. The question of how to pay for the proposed strategies, however, is seldom addressed satisfactorily. This raises questions regarding the effectiveness of expenditures in producing growth, an extremely important factor in the design of strategies for development and poverty alleviation. Empirical work by Lopez provides a good example of the importance of priorities. Lopez finds that while government spending can slightly elevate agricultural gross domestic product (GDP) per rural person, a mix of spending on public goods and private subsidies is much more significant. A reallocation of 10 percentage points of total rural public expenditures (for example, from 40 to 50 percent spending on public goods) raises agricultural GDP per rural person by 2.3 percent—without spending a dime more in total. A dollar added to total rural expenditures would be shared by both public and private goods. In contrast, an intramarginal shift of a dollar from private to public goods is claimed entirely by public goods and is lost to private subsidies. This leads to more money for public goods and less encouragement for rent seeking, less overinvestment in subsidized activities, and delays in restructuring away from subsidized investments.

anti-export bias, which was employed to notable effect in Chile following economic reforms; the result was increased employment demand for the unskilled and a significant reduction in poverty.

Very poor countries, with smaller income inequalities and limited fiscal resources, should emphasize pro-growth policies. For middle-income countries, where income inequality is higher and fiscal resources are less constrained, pro-growth policies should be complemented with policies aimed at reducing inequality. Within middle-income countries (most in Latin America) regional disparities appear to be increasing, creating a possible trade-off between aggregate growth and geographic equity. This is a concern because poor people often lack the necessary resources to allow them to migrate.

What Is the Pathway from Poverty to Growth?

Growth is important for poverty reduction, but does poverty impede growth? In a notable publication aimed specifically at Latin America, *Poverty Reduction and Growth: Virtuous and Vicious Circles*, Perry et al. discuss several channels through which poverty does in fact influence overall economic growth:

1. The poor often do not have access to credit markets and lack land titles or other means of supplying collateral; hence, potential investments lie dormant.
2. Poverty and illness are related: improving health improves productivity.
3. The quality of schooling often varies according to income. Inferior schooling is bad enough for adults in poor households, but they often can't afford to keep their children in school for long and, thus, miss out on the higher returns

to education that could accrue in the next generation with each year of schooling. Lower education levels reduce the earning potential and mobility of labor. Education also affects health, child mortality, and household size.

4. Poor households often lack the financial wherewithal to absorb labor-market shocks and the human capital that provides labor mobility to respond to those shocks. Investing in human capital or in a specialized activity, like any other investment, is a decision that balances expected returns with risks. The greater the risk, the higher the returns ought to be. Without adequate insurance and credit markets, poor households face higher risks of investment and so underinvest compared with households with more diversified income sources or access to funds to tide them over shocks.
5. Poorer regions and countries simply have fewer people ready and able to initiate or take advantage of productivity-enhancing innovations.
6. Furthermore, without infrastructure and human capital, poor regions do not attract investments from outside. And people living in those regions face even greater obstacles to seeking opportunities elsewhere.
7. Regional income disparities, especially when they overlap with disparities related to ethnicity or race, can sometimes lead to regional political problems and to a subsequent increase in the risks associated with all types of investments.

Concluding Comments

The Latin American economic reform process offers valuable lessons. Beginning in the 1980s, the reforms were deep and wide, and they were introduced during times of major macroeconomic crises and hence government spending restrictions. Not all expectations for reforms were fulfilled, but most countries have indeed undergone significant structural change. And despite early fluctuations, significant growth is occurring in many countries. An unanticipated outcome is that the reforms prepared Latin American economies for the now ongoing process of globalization.

The critical lesson for reducing poverty is that growth must be pro-employment—particularly of unskilled labor. In the long run, the main factor for both growth and poverty reduction appears to be education. The record of educational coverage and quality in Latin America is still disappointing overall, however—certainly compared to the East Asian experience. On the positive side, several countries are now emphasizing improved education for poor people.

For Further Reading: D. Dollar and A. Kraay, "Growth Is Good for the Poor," *Journal of Economic Growth* (Vol. 7, No. 3, 2002); R. Lopez, "Why Governments Should Stop Non-Social Subsidies: Measuring Their Consequences for Rural Latin America," prepared for the Office of the Vice President for Latin America and the Caribbean (Washington, DC: World Bank, 2005); G. E. Perry, O. S. Arias, J. H. Lopez, W. F. Maloney, and L. Serven, *Poverty Reduction and Growth: Virtuous and Vicious Circles*, World Bank Latin American and Caribbean Studies (Washington, DC: World Bank, 2006); M. Ravallion, "Growth, Inequality, and Poverty: Looking Beyond Averages," *World Development* (Vol. 29, No. 11, 2001); M. Ravallion, "Pro-poor Growth: A Review of What We Know (and What We Don't)," prepared for the Poverty Group (Washington, DC: World Bank, 2004); C. G. Tsangarides, D. Ghura, and C.A. Leite, *Is Growth Enough: Macroeconomic Policy and Poverty Reduction*, IMF Working Paper (Washington, DC: International Monetary Fund, 2000).

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Suggested citation: Alberto Valdés and William Foster. 2007. Economic Reforms to Stimulate Growth and Reduce Poverty: The Latin American Experience. 2020 Focus Brief on the World's Poor and Hungry People. Washington, DC: IFPRI.

The views expressed in this brief are those of the author(s) and are not necessarily endorsed by or representative of IFPRI, or of the cosponsoring or supporting organizations.

This brief was prepared for a policy consultation process coordinated by IFPRI and focused on the World's Poor and Hungry People. IFPRI gratefully acknowledges the contributions of: Asian Development Bank (ADB), Bill and Melinda Gates Foundation, Canadian International Development Agency (CIDA), Deutsche Welthungerhilfe (German Agro Action), European Commission, German Federal Ministry for Economic Co-operation and Development, with Deutsche Gesellschaft für Technische Zusammenarbeit (BMZ/GTZ), International Development Research Centre (IDRC) Canada, and Irish Aid.



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