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Addressing Inequality, Informality and Low Productivity

Policy Options in Times of Uncertainty

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Paolo Giordano, Principal Economist of the Integration and Trade Sector of the IDB coordinated and supervised the study.

Policy Discussion Brief

Addressing Inequality, Informality and Low Productivity

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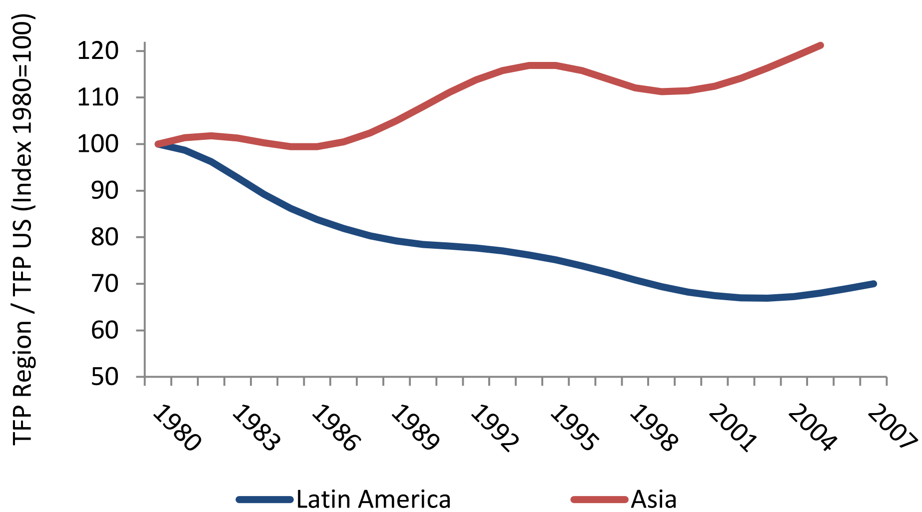
Inter-American Development Bank

Rethinking Reforms to Escape Suppressed World Growth

Projections for Latin America and the Caribbean over the next years point to lower growth. In a situation of suppressed growth in the main world economic blocs, and in view of the limits of fiscal and monetary policy in boosting growth in the region, policymakers should consider pro-growth structural reforms that have the potential to rectify the significant misallocation of resources and increase productivity.[1]

Economists have long argued that improving productivity is essential for long-run, sustainable growth in per capita income. Unfortunately, productivity growth in Latin America and the Caribbean has lagged both advanced economies, such as the United States, and particularly the emerging economies in Asia.

Figure 1. The Relative Productivity Decline in Latin America and the Caribbean



Note: TFP denotes Total Factor Productivity.
Source: Rethinking Reforms (2013) based on Daude and Fernández-Arias (2010).

To realize sustainable gains in income per capita in the region, barriers to stronger productivity growth must be reduced. What type of policies can achieve this? One clear point of departure is to think about policies that would create the proper economic environment for firms and agents to reallocate factors efficiently.

Simulations suggest that reducing economic misallocation could impact growth significantly. For the median country in the region, reforms to reduce the current level of misallocation to that of the United

[1] See Powell, coord. (2013) *Rethinking Reforms. How Latin America and the Caribbean Can Escape Suppressed World Growth*. 2013 Latin American and Caribbean Macroeconomic Report. Inter-American Development Bank. March 2013. This report represents the basis for the present text. See also Daude and Fernández-Arias (2010) *On the Role of Productivity and Factor Accumulation in Economic Development in Latin America and the Caribbean*. Inter-American Development Bank.

States over a 10-year period are estimated to yield roughly an additional one percent per annum of growth, which when accumulated over, say a 10-year period, is a significant amount indeed.

Countries in the region are in quite different positions with regard to the structural impediments to growth and hence may wish to focus on different areas of reform. Considering the region as a whole, reforms in trade and finance have advanced well but other areas have lagged. There is surely much work to be done to improve education, competition in product markets, tax systems, domestic savings and investment, and the workings of labor markets.[2] The IDB is working in many of these areas. The two last topics: labor market reforms and investment in infrastructure have been the focus of recent studies, but other areas remain important as well, and indeed they tend to interact with one another.

In the area of labor market reform, there appears to be considerable space for further reforms and a clear association between economic misallocation, reflected in labor and firm informality, and lower productivity. IDB studies suggest an integral approach to labor market reforms, tailor-made to individual countries' institutions. In countries with high rates of informality, reforms may focus on this problem. Informality tends to go hand in hand with a higher proportion of smaller, less-efficient firms, high worker turnover, a less-educated and less-trained workforce, the likelihood of illegal practices, and reduced access to credit. These features tend to reduce productivity. Thus, a strategy that seeks to reduce informality could potentially have a large payoff.

Latin America and the Caribbean also suffers from a significant gap in the quantity and quality of infrastructure services, with low investment in this sector. While there is a chicken-and-egg debate on whether low savings are a determinant of low investment or vice versa, IDB studies suggest that countries may wish to work on both fronts. On the one hand, countries could enact measures to deepen long-term domestic savings in domestic currency. On the other hand, they could improve regulatory and institutional environments to attract greater investment.

There is a clear window of opportunity to increase domestic savings. Pension, social security, and tax reforms may have the most significant impact on savings levels and, as in the case of labor markets, these reforms should be tailored to individual countries. While public-private partnerships do not necessarily increase aggregate investment, they may offer one vehicle to improve existing regulatory or institutional arrangements and the efficiency with which projects are carried out. More generally, such improvement can be made whether the investments are public, private, or some combination of the two. International experience suggests that increases in domestic savings combined with improvements in regulatory institutions are feasible and may yield significant payoffs in terms of infrastructure provision and growth.

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[2] See Pagés, ed. (2010) *The Age of Productivity: Transforming Economies from the Bottom Up* for an analysis of the determinants of productivity; Corbacho, Fretes Cibils, and Lora (2013) *More than Revenue: Taxation as a Development Tool* for a review of tax systems in Latin America and the Caribbean and how they may be reformed to promote development; and Bassi et al. (2012) *Disconnected: Skills, Education, and Employment in Latin America*, and Cabrol and Székely (2012) *Educación para la transformación* for work on the current state of education in the region and suggestions regarding priority areas for reform.

The World Bank Group

Latin America's Productivity Battle Cannot Wait another Day

For almost a decade, emerging market economies (EMs), including several countries in Latin America and the Caribbean (LAC), were regarded by analysts and investors as new engines of growth. Their growth preceding the global financial crisis sparked an enthusiasm that, after a short pause during the 2008 crisis, was cemented by vigorous recoveries in 2009 and 2010. A new story line seemed to dominate: thanks to deep structural changes, both domestic and global, EMs' potential had finally arrived.

In the past few months the enthusiasm for the emerging world appears to have soured. A notable slowdown in EMs has cast doubts on the sustainability of their high growth rates of the past decade and has revived old fears of macro and financial turbulence. Headlines such as "submerging economies" have become common in financial periodicals.

The truth is that major LAC economies experienced lackluster growth for decades prior to the boom of the 2000s. At the beginning of the 20th Century the weighted average of the region's GDP per capita was a bit over 30 percent that of the United States. By 2010, that ratio was in fact a bit below 30 percent.

This implies that over 110 years, the large economies of Latin America grew less than the United States and, more importantly, were unable to take advantage of their relative underdevelopment by catching up to the United States and other developed economies that became the source of technologies that have become commonplace around the globe. LAC did not need to invent; just to imitate and adopt technologies, as some economies in East Asia were able to do.

All this is not to say that the recent enthusiasm for LAC's EMs was unsubstantiated. The enthusiasm was justified due to the substantial and unprecedented social progress seen in the region during this recent growth spurt:

- Nearly 70 million people were lifted out of poverty in the past decade.
- Approximately 50 million people entered the ranks of the middle class between 2003 and 2009.
- Income inequality, as measured by the Gini coefficient, has fallen steadily, dropping from its peak of 0.58 in 1996 to the lowest level ever recorded in the region, 0.52 in 2011, more than 10 percent lower.
- About one third of poverty reduction was due to social policies that transferred incomes to the poor. Yet two thirds were due to the generation of labor market income during the boom years.[3] In other words, growth is required to sustain poverty reduction and middle class expansion.

[3] See Ferreira, Messina, Rigolini, Lopez-Calva, Lugo and Vakis (2013) *Economic Mobility and the Rise of the Latin American Middle Class*. The World Bank: Washington, DC.

What makes the productivity challenge pressing is precisely that social progress has been tied to growth. Thanks to current policies, social programs can be maintained in the short term. The risk is that these gains might be reverted if growth remains low for too long.

With global tailwinds receding, the region will need to turn to its own devices to spur growth. Those devices have only one name: productivity. With scant domestic savings and receding external capital inflows, income growth can only be sustained by productivity gains.

Leaders in the region are fully aware of the importance of boosting productivity. It is a battle that cannot wait another day precisely because productivity reforms are likely to take time to payoff.

But what is this battle specifically about? It is about establishing an enabling environment for Latin American entrepreneurs to emerge, compete and innovate. It is about building an innovative entrepreneurial class in economies where top-notch firms (those that export goods, services and even capital) no longer look tepid in contrast to entrepreneurial superstars elsewhere.[4]

Beyond generalities, the main elements of an enabling environment for entrepreneurship and innovation include[5]:

- Building human capital. The challenge of raising the quality of education remains, but it goes well beyond test scores. For example, LAC has a historic deficit of engineers, dating at least to the early 20th Century.
- Improving logistics and infrastructure. Modernizing ports, transport, and customs can add a competitive edge to products from the region. The current infrastructure deficit also needs to be addressed to end capacity constraints that become evident at low growth rates.
- Enhancing competition. While the Region has globalized, many industries remain sheltered from competition. This has the dual negative effects of reducing productivity growth in those sectors and handicapping the export sector that relies on their services and intermediate goods.
- Improving the contractual environment. Although it is not the only relevant aspect of domestic institutions that affect productivity, innovation is unlikely to take root without the adequate protection of intellectual property rights.

With LAC's recent social gains growing demands for access to quality services have increased. Middle classes expect not only income gains so that their children will see even more progress in the future, but also improved public services for the current generations. With increased productivity, private incomes will rise, and thus enhance public revenues and the State's capacity to invest in service delivery. In time, if we win the productivity battle, we will enter into a virtuous cycle of stronger public sectors, higher growth, and opportunities for all.

[4] Lederman, Messina, Pienknagura, and Rigolini (2013) *Latin American Entrepreneurs: Many Firms but Little Innovation.* Forthcoming.
[5] Idem.

Economic Commission for Latin America and the Caribbean (ECLAC)

Facing Structural Heterogeneity to Move Forward in Productivity, Equality and Formality

The three concepts are related to the structural heterogeneity that characterizes the region and although the analysis and corresponding policies are not entirely covered by factors linked to this characteristic, ignoring it leads to policy responses that are lacking in their scope. Specifically:

- Latin American and Caribbean countries suffer from both external productivity gaps (relative to other countries) that have not seen a significant narrowing, and from internal productivity gaps between different sectors and subsectors within the economies. The outsized share of low productivity sectors in the region's economies acts as an impediment to increases in aggregate productivity. Job creation in sectors of high and medium productivity, as well as the promotion of productivity increases in sub-segments of low productivity sectors that have the potential for growth are key in closing both gaps.

- There is circular causality between the low levels of productivity and high incidence of informality. In this way, factors that encourage greater informality also impede productivity increases. However, the empirical evidence indicates that the opposite causality is more important, given that for the most part informality is due to the productive weakness of low productivity sectors.[6] This in turn influences cost-benefit relationships in terms of formalizing work, rendering the formalization of work unattractive for the majority of these sectors.

- Low productivity and high informality, linked in this way, lead to low levels of labor income, low quality employment and a lack of access to (contributive) social security systems. As a result, large gaps open with respect to workers with access to employment in sectors with higher levels of productivity, and that have formal labor relations.

In terms of policies, this focus enables progress on the three "fronts" simultaneously through the identification of structural heterogeneity as the substrate that connects them. Consequently, a reduction in this heterogeneity opens spaces to increase productivity and reduce informality and inequality without generating tensions in the pursuit of these objectives in the three sectors. The key policies related to these goals have the key objective of increasing inter- and intra-sectoral linkages, increasing competitiveness in the different sectors, in such a way so that there is an intensification of productive linkages at the national and regional level.[7]

Clearly this does not mean that the three phenomena (high levels of inequality, low levels of formality and productivity) are caused exclusively by this heterogeneity, nor that policies directed at it are sufficient to definitively solve the problems related to them. From the macroeconomic perspective, also

[6] See, for example, Loayza and Rigolini (2006) *Informality Trends and Cycles,* World Bank Policy Research Working Paper #4078 who find that "80% of the variation in informal employment can be explained by the variation of GDP per capita".

[7] For further reading on this topic see ECLAC (2012) *Structural change for equality. An integrated vision for development,* Thirty-fourth session of ECLAC, San Salvador, 27th to 31st August 2012.

key is the creation of conditions for a sustained and diversified increase in investments, especially in the tradable sectors, in order to increase aggregate productivity, create linkages (including with small and medium enterprises, SMEs) and quality employment. In order to achieve this, ECLAC suggests establishing, on a national level, a social pact for investment and productivity.[8]

In addition, in order to advance on these three "fronts", measures are required to focus directly on each one of them, including the following:

- Measures to encourage labor relations that favor virtuous circles for the promotion of productivity and the adequate distribution of its benefits.
- Measures to promote the insertion of vulnerable groups in the labor market (for example, programs for the care of children and for training).
- Strengthen the redistributive role of fiscal policy.
- Appropriately designed non-contributive social protection programs.
- Strengthen systems of research and innovation.
- Programs to promote formalization of work.
- Strengthen labor inspection systems.

[8] See ECLAC (2013) *Three decades of uneven and unstable growth*, Economic Survey of Latin America and the Caribbean 2013, Santiago, Chile, and ECLAC (2013) *The current international context and its macroeconomic repercussions for Latin America and the Caribbean*, Santiago, Chile.