EMERGING FROM THE PANDEMIC TUNNEL with Faster Growth and Greater Equity: A Strategy for a New Social Compact in Latin America and the Caribbean

COVID-19

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Emerging from the Pandemic Tunnel with Faster Growth and Greater Equity: A Strategy for a New Social Compact in Latin America and the Caribbean

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It is by no means certain that there will be a vaccine or therapeutic within the much-commented period of 12 to 18 months. Of note, it took years to develop a vaccine for other deadly viruses (e.g., ebola), and no vaccine has ever been developed for the SARS coronavirus.
Introduction

For as long as the pandemic lasts, Latin America and the Caribbean (LAC) will be traveling through a tunnel full of uncertainty. Above all, we do not know how long the tunnel is—that is, how much time will pass before therapies or a vaccine are developed or until we have learned to live with a virus whose true destructive nature is still unknown.

However, it is certain that countries will face enormous economic and social challenges upon exiting the tunnel, and the strategies of the past will not be adequate to respond to them. Even before the crisis struck, the challenges were growing due to the slow creation of new opportunities for productive employment and the persistence of high inequality. When we emerge from the tunnel, a new social compact will be needed to contend with increased poverty, inequality, unemployment, and informality, as well as a huge number of firms either going bankrupt or on the verge of bankruptcy, enormous losses of human capital—fiscal situations that are more difficult than at any time over the last 20 years—and severely weakened financial sectors. Compounding these challenges will be new barriers to inclusive growth. Until there is a vaccine, consumers and workers will remain anxious, reluctant to participate in those very economic activities that were so important to them before. Globalization—the movement of capital, goods, and people—will contract, with significant impacts on value chains.

Returning to the modest growth seen prior to the COVID-19 crisis is not an acceptable response for the LAC region. Furthermore, the policy responses during this crisis will have to be of better quality than those implemented during the financial crisis of 2008–09 that, to a large degree, resulted in an expansion of public expenditure with little to show for it in terms of inclusive growth. Instead, it financed higher public sector salaries and transfers that mostly benefited better-off sectors, leading to high levels of public debt with no significant improvement in growth and equity.

This work describes policy options that will enhance countries’ chances of tackling the economic challenges of the crisis, with an emphasis on growth and equity. They take as a point of departure that the region’s fiscal situation and its access to sovereign credit markets are much more restricted than in previous crises: policy reforms that go beyond the fiscal sphere are needed to accelerate economic recovery. The options are ambitious, but the ambition responds to necessity.

The document reaches the following conclusions to assist countries in organizing the ongoing debate around the many policy options that governments face:

1. While the region is still in the tunnel, the first priority is to tackle the pandemic and limit economic costs. Strengthening the health system and increasing the availability of testing and tracing mechanisms to tackle the health crisis is critical not only for health, but also for economic recovery. Limiting the severe losses of income for poor and informal households is a humanitarian imperative. Likewise, avoiding the destruction of the productive base of the economy and of the human capital of children, young people, and workers is key to ensuring a more rapid recovery upon emerging from the tunnel.

2. But limiting losses, or even reversing them and returning to the levels of growth and equity of the pre-crisis period, will be insufficient. Social pressures for more equity and more economic opportunities had already emerged in the months before the crisis.
The crisis itself has underscored the consequences of neglecting growth and social protection: less capacity to resist the crisis not only in terms of health, but also in economic and social terms.²

3. As Diagram 1 illustrates, while still inside the tunnel two complementary sets of policies must run side by side: the health and damage limitation policies, and those that prepare the countries to grow more rapidly and inclusively after exiting the tunnel than they did before the crisis. Countries that, while still in the tunnel, adopt policies to conserve human capital and the relationships between economic actors—banks and borrowers, firms and workers, producers and their clients—will rebound faster upon leaving the tunnel. Countries that forge inclusive and sustainable growth policies inside the tunnel that they will continue upon leaving it will have greater financing options now to deal with the current crisis. Such announcements, especially when enshrined in law, increase the confidence of citizens, firms, and financial institutions.

4. The new orientation of public policies toward inclusive growth will represent a significant change of direction in the region’s policies and its institutions. A new social compact will enable countries to respond to economic, social, and global challenges, such as climate change, that they were already facing before the crisis and that have worsened. It implies fiscal policies that, once the pandemic’s most pressing effects have been addressed, reallocate expenditure to line items that will have greater impact on inclusive and sustainable growth, alongside a new institutional framework that ensures the efficiency of such expenditures. It demands policies that encourage competition and remove barriers to entry in the private sector, with an institutional framework that creates opportunities for all rather than prioritizing protection for the few. It also includes policies that demand greater efficiency in the public sector, along with an institutional framework that rewards civil servants and sectors that innovate.

5. If it is to bounce back quickly when it emerges from the tunnel, the region cannot depend on fiscal stimuli, as it has done in previous crises. Limited fiscal space and restricted access to financial markets will make this difficult. Nonetheless, within the range of pro-growth policies, some will have a better chance of generating faster short-term economic growth and reductions in unemployment. Such is the case, for example, of redirecting spending toward infrastructure, which often has a high multiplier effect in terms of both economic activity and employment, as well as policies to reduce non-payroll costs to create jobs. While these measures would help promote rapid recovery after exiting the tunnel, they will be insufficient to narrow the gaps of equity and growth left by the pandemic; countries will have to consider which deeper reforms they will prioritize, from a long list of possibilities, to ensure sustained growth over the medium term.

6. A new social compact will place huge demands on governments. They must make the promise of the new compact believable and act vigorously when they address the various fiscal and institutional reforms implied by the compact. Transfer policies will have to be rethought to make them more efficient and inclusive and ensure greater outreach to vulnerable populations. They should also create safeguards that protect workers against cyclical shocks and enhance service coverage and quality, especially in the areas of health and education services for the most vulnerable. If economic opportunities are to multiply, the web of regulations whose main consequence has been to obstruct the entry of new and more productive firms will have to be untangled. On the fiscal side, governments must be agile and capable of carrying out unprecedented fiscal gymnastics in large-scale budget reallocation. Inside the tunnel, reallocation must tackle the pandemic, saving firms and jobs and financing transfers to households. Once outside the tunnel, there should be massive reallocation toward spending that boosts sustained growth and inclusion.

² The index of deaths caused by natural disasters in poor countries is around five times higher than that of rich countries. All countries in the world were able to implement lockdown policies, but only the rich countries could sustain the closures without making the poor and the unemployed pay excessive costs.
7. A new social compact will allow the societies of the LAC region to deal with various other challenges that they face. With each succeeding year, climate change and high levels of pollution and environmental degradation affect the region more intensely and at a faster pace. Societies that grow more and with more equity can count on more resources to mitigate and slow climate change, control locally generated pollution, and strengthen environmental protection. Furthermore, they will be able to reach political agreements that enable them to carry out such an effort, since the compact will reassure citizens that the agreements will ultimately raise the welfare of all and not favor the few. Likewise, with a new social compact, countries will be better placed to resist the effects of de-globalization and other significant challenges, such as migration.

8. The new social compact will enable the region to more quickly narrow other gaps between it and more advanced economies. For example, a clear sign of the region’s public sector inefficiency and low private sector productivity is the wide digital gap between LAC countries and the advanced economies. By fostering efficiency within the public sector, keener competition, and the creation of more firms in the private sector, the incentives to close the digital gap will increase significantly.
Economic Recovery:
More Limited Options for Latin America and the Caribbean than for Advanced Economies

The countries of the world that had higher incomes before the pandemic and had built the best social protection networks for their most vulnerable members entered the crisis better prepared to soften its impact. Their finance ministers enjoyed greater access to financing, giving them significant leeway to tackle the health crisis. With greater capacity to limit losses of human and business capital while inside the tunnel, they are also better prepared to accelerate their growth when they emerge from it.

The options for economic recovery in LAC are more limited. The pandemic struck a region already weakened by low growth, largely owing to the policies followed in previous decades. In particular, the response to the 2008–09 financial crisis resulted in more debt, higher public sector salaries, and more transfers, not all of them targeted toward the most vulnerable and contributing little to inclusive growth.

Over the past six decades, income levels in the region showed no signs of converging with those of the advanced economies (Figure 1). There was some progress toward reducing inequality (Figure 2), but largely due to factors other than public policy and leaving a gap that was still enormous compared to advanced economies. The poorest among the rich (those in

3 Figure 1 compares per capita income, adjusted for purchasing power, of each region with respect to the United States. In 2019, LAC countries had approximately the same proportion as before the 2007-08 crisis, which was the same as in 1960. In contrast, although in 1960 their situation was already much better than that of LAC, the other advanced economies increased 20 percentage points with respect to the United States, narrowing the gap to 20 percent in 2019. The growth of the emerging Asian economies is outstanding and is clearly evident in the figure. The nearly 90 percent gap with the United States in 1960 was reduced to less than 50 percent in 2019, compared with the 80 percent gap that LAC has maintained throughout almost the entire period. Moreover, over the last 20 years, despite having enjoyed higher average growth than in previous decades, the productivity gap with the developed countries has continued to widen. See Cavallo and Powell (2018).

4 Figure 2 reveals that inequality rates have declined, narrowing a part of the gap in the inequality rate with advanced economies. But public policy has not contributed much to this slight narrowing, and the gap continues to be nearly as wide as that of Sub-Saharan Africa, and twice the size of the gap between the emerging Asian economies and the more advanced economies.
decile 9) earn 10 times more than the richest among the poor (those in decile 2). Poverty and vulnerability to poverty continue to be high. Only 4 out of every 10 people in LAC are sufficiently above the poverty line so as to enjoy a certain cushion that, in the event of a deep recession, would protect them from falling below it.

**FIGURE 1:** Evolution of per Capita GDP (PPP) Relative to the United States, Regional Average (percent)

![Graph showing GDP evolution](image-url)

**SOURCE:** Authors’ elaboration using data from Feenstra, Inklaar, and Timmer (2015). For data subsequent to 2017, value projections were made using the growth rate of the indicator available in the WEO database.

**ADVANCED ECONOMIES:** Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

**LATIN AMERICA AND THE CARIBBEAN:** Argentina, Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Trinidad and Tobago, Uruguay, and Venezuela.

**EMERGING ASIAN ECONOMIES:** China, Hong Kong, Indonesia, Malaysia, Singapore, South Korea, and Thailand.

Adding to these challenges is the fiscal fragility of the majority of the region’s countries. Before the COVID-19 crisis, LAC already faced a weaker fiscal situation than the one that prevailed on the cusp of the financial crisis of 2008–09. The fiscal gaps, on average, were 2.4 percent of GDP wider, and the level of debt was 22 percentage points of GDP higher. The current response to the COVID-19 crisis will drive up public debt still further. Depending on the possible GDP trajectories—with reductions that might hit 6 percent—and an average increase of public expenditure of around 2.7 percent of GDP to tackle the pandemic crisis, debt could rise by an additional 15 points of GDP, reaching as high as 73 percent of GDP in 2022.5 This situation may raise doubts about sustainability and lead to macroeconomic problems that will ratchet up the cost of borrowing. All of this, without the possibility of fiscal stimulus to accelerate economic recovery, highlights how difficult it will be to design stimulus policies without reallocating expenditure.

Figure 3 shows that fiscal constraints have already had a significant impact on countries’ fiscal response to the pandemic. The few countries with low levels of debt, such as Chile and Peru, announced measures to mitigate the crisis that amount to 15.1 and 11.1 percent of GDP, respectively—much higher than the rest of the region. In addition to low levels of debt and fiscal accounts in good order, they also enjoy easy and less onerous access to international credit markets. The measures announced by the other countries, with higher levels of debt and financing costs, represent only 4.1 percent of GDP. Only 2.7 percent of GDP corresponds to public spending measures, while the rest are credit expansion measures.

**FIGURE 3:** Public Debt and Resources Announced to Mitigate the Pandemic

**SOURCE:** Pineda, Pessino, and Rasteletti (2020).
A Strategy for Economic Recovery: A Path toward Inclusive Growth

The strategy outlined below responds to three fundamental constraints facing the region. First, in contrast to their possibilities in previous crises, and in contrast to the advanced economies during the pandemic crisis, the great majority of the region’s countries can count on only limited fiscal stimuli to boost economic recovery. They will be unable to rely on strategies whose sole objective is to increase aggregate demand. Second, even if they were possible, these short-term stimuli have proved insufficient to accelerate inclusive growth. Third, given the depth of the shock, a slow economic recovery is unacceptable.

There are four central themes in the options for economic recovery:

- Faced with limited fiscal space, reallocate expenditures to those that favor growth and equity, while respecting other demands such as public health; and make the tax structure less discouraging to productive economic activity so that it can better support equity and fiscal stability upon exiting the tunnel.

- Instead of seeking inclusive growth only through fiscal policies that increase aggregate demand, target reforms that lower the costs of economic activity, searching for and eliminating regulatory barriers and taxes that have negative impacts on the cost of entrepreneurship and job creation.

- Given the need to trigger a fast economic recovery upon exiting the tunnel, from the menu of fiscal and regulatory reforms prioritize those that can be implemented rapidly and that will have a direct and immediate impact, such as reallocation to infrastructure spending and reduction of non-salary costs.
Medium- and long-term reforms can have immediate effects on the economic actors whose backing is key for economic recovery. Governments that, while inside the tunnel, make credible promises to lower the costs of creating employment and maintaining fiscal stability once the health crisis has subsided will experience faster economic recovery even inside the tunnel. Such promises will facilitate a difficult decision already faced by firms: invest now to reduce the risks of infection and reopen rapidly, or postpone reopening until there is more certainty regarding future government policies. Credible promises will also facilitate government negotiations with financial markets in the short term, boosting their capacity to complement the measures with further fiscal stimuli.

The reform options outlined below are organized into two phases, inside and outside of the tunnel. In brief, there are effectively three priorities in the first phase, while still inside in the tunnel:

- Avoid systemic crises, both fiscal and financial.
- Limit losses that will hamper recovery, in both health and economic terms.
- Begin rebuilding the social compact, establishing a clear pathway of reforms that will lay the foundation for inclusive growth once they emerge from the tunnel.

Once they exit the tunnel, after the worst of the health crisis has passed, governments should have three priorities:

- Reverse pandemic-induced losses in human and intangible capital.
- From the menu of fundamental reforms, begin by adopting those that lend themselves to rapid implementation and that will have an immediate impact: redirecting public expenditure toward sectors that stimulate the recovery more rapidly and facilitating measures that can stimulate higher employment early on, reducing non-salary costs and other operating costs for firms.
- Advance the inclusive growth agenda so that, in contrast with previous crises, countries can begin to converge with advanced economies and address the challenges left unattended before and during the pandemic, such as inequality and environmental sustainability.
Emerging from the Pandemic Tunnel with Faster Growth and Greater Equity
Priorities and Options
Inside the Tunnel to Accelerate Economic Recovery

Inside the tunnel—the current period, when the entire world is struggling to fight a highly contagious virus, without a cure, without a vaccine, and without herd immunity—countries are suffering from the direct economic impact of the pandemic. Their three priorities are: avoid systemic crises, limit losses that impede economic recovery, and establish a pathway to fundamental reforms to support economic recovery and faster inclusive growth after leaving the tunnel.

Avoid Systemic Crises

The highest priority while inside the tunnel is avoiding a systemic crisis. This is a significant threat, given the magnitude, suddenness, geographic reach, and duration of the COVID-19 pandemic. In more than 100 years, nothing similar has ravaged the world, making it difficult to learn from past pandemics about how best to deal with the economic consequences of the current one. In contrast, the most recent financial disasters, although not of the same nature, do yield important lessons.

In a fiscal crisis, a country lacks the capacity to meet a significant portion of its fiscal commitments: its debts, pensions, salaries, and social transfers. Countries either make massive public expenditure cuts or suffer hyperinflation, in both cases worsening prospects for growth. In the current circumstances, the threat of fiscal crisis in depressed and low-income economies has risen, with new spending aimed at fighting the pandemic and its social costs. The threat of a fiscal crisis is greater in countries that already exhibit fragile fiscal positions, with significant debt and restricted and expensive access to financial markets.

The pandemic also raises the danger of financial crisis due to its impact on the real economy. Companies with no revenues can hardly be expected to meet their financial obligations. Permanent and massive default would threaten the solvency of the banking system and the operation of the payments system.

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7 What we have learned from the pandemics of history is that they were followed by decades of depressed investment. See Jordà, Singh, and Taylor (2020).
In fact, the pandemic has unleashed unprecedented levels of default. Eighteen of the region’s countries, from Barbados and Chile to Uruguay and Trinidad and Tobago, have announced loan repayment moratoria, which could make the banking situation even more difficult, but which also may simply reflect the spectacular fall in firm revenues. A recent survey in Argentina indicates that 72 percent of firms have seen declines in their sales of more than 60 percent (see Table 1). But smaller firms suffer the most: whereas only 56 percent of large firms (300 employees or more) experienced declines in their sales greater than 60 percent, this figure was 76 percent for smaller firms (50 employees or fewer).

**TABLE 1: Declines in Sales in Argentine Firms**

<table>
<thead>
<tr>
<th>Number of employees</th>
<th>Less than 30%</th>
<th>30% to 60%</th>
<th>More than 60%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 to 50</td>
<td>8.4%</td>
<td>15.4%</td>
<td>76.2%</td>
</tr>
<tr>
<td>50 to 150</td>
<td>22.8%</td>
<td>22.8%</td>
<td>54.4%</td>
</tr>
<tr>
<td>150 to 300</td>
<td>20.8%</td>
<td>12.5%</td>
<td>66.7%</td>
</tr>
<tr>
<td>300 or more</td>
<td>32.0%</td>
<td>12.0%</td>
<td>56.0%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>11.7%</strong></td>
<td><strong>16.1%</strong></td>
<td><strong>72.2%</strong></td>
</tr>
</tbody>
</table>

**Source**: CEU UIA (2020).

The crises of the 1980s and 1990s provide two lessons regarding the potential fiscal and financial consequences of the pandemic for highly indebted countries. First, in the event that they are eventually struck by the pandemic depression and they lack the capacity to repay debts already incurred, they must immediately recognize that the debt is unsustainable to avoid counterproductive fiscal contractions, prolonged recession, and even social upheaval or political instability. This will not be a generalized situation, but for some countries a sustained period of low income and a sharp increase in expenditure may leave them wholly unable to meet their debt obligations. History shows that orderly, rather than unilateral, debt restructuring opens the door to further financing.

The second lesson is the need to guard against the possibility that a banking crisis emerges on top of a sovereign debt crisis, producing an explosive mix. The threat of a banking crisis during this pandemic is different than in other crises. It does not arise from the behavior of the banks themselves, as when they recklessly acquire overly risky assets. Rather, with the economic shock of the pandemic hitting the real economy, firms that prior to the crisis were reliable borrowers are suddenly unable to repay and face the risk of bankruptcy.

Countries have three tools at their disposal to ward off a banking crisis. The first, a non-fiscal one, is to relax financial regulations so that banks can renegotiate lending agreements with borrowers without falling afoul of banking regulations. The other two tools depend on each government’s financial situation, that is, its level of borrowing, including nonbudgetary obligations. One is to give credit guarantees to firms so that they can continue to meet their credit obligations. Ideally, those guarantees should target firms whose inability to repay debt is due entirely to the pandemic—they entered the tunnel in sound condition—and once the economic burden of the public health crisis has been lifted, they will once again be in a

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8 See Reinhart and Rogoff (2014).
9 Under the Baker Plan of the 1980s, it was not recognized that support for liquidity is not enough when there are also problems of solvency. By failing to establish clear rules for solving excessive public debt, the Baker Plan levied an implicit tax on investment, which slowed growth for a long time. See Cavallo and Fernández-Arias (2013). In contrast, under the Brady Plan in the 1990s, there was an orderly reduction of the debt in a growth-friendly economic environment. See Frenkel (1989).
10 See Didier, Huneeus, Larrain, and Schmukler (2020).
position to pay. This measure will not be sufficient to avoid a banking crisis if there are many firms without repayment capacity and if they are concentrated in sectors such as tourism, which will take some time to recover. In this case, the other tool available to governments is to provide guarantees to the banks themselves.

The latter two solutions imply significant increases in governments’ fiscal liabilities that, in countries with the most fragile fiscal situations, would only aggravate their debt crisis. While the debt crisis persists, this implies privatizing the public banks that are experiencing problems, liquidating rather than recapitalizing some banks, and focusing support on the key functions of the banking system, such as the payments system.\textsuperscript{11}

**Limit Losses Inside the Tunnel**

The second priority inside the tunnel is to limit the losses that are the direct result of the pandemic: infection and mortality, social and economic losses resulting from social distancing, and those that result from the policies of containment, especially unemployment, massive bankruptcies, and school closings. All those losses take an enormous toll on people. Blackman, et al. (2020) outline the region’s options with respect to softening the immediate effects of the crisis via transfers to the most affected households and support for the productive base of the economy.

The present document focuses on the losses that will have the greatest impact on inclusive growth once the health crisis has subsided and on policies that limit and remedy those losses:

- Strengthen the health sector to reach the end of the tunnel faster
- Limit the loss of human capital caused by school closures
- Avoid the loss of firms’ intangible capital—their employees’ specialized knowledge, valuable relationships with suppliers and clients, and the tacit practices that add so much to their productivity—which would disappear should these firms cease to do business.

Among the public policy alternatives presented below, fiscal options are key to limit avoidable losses and compensate for the unavoidable and to accelerate recovery. However, in view of the region’s negligible fiscal space, implementing them calls for massive reallocation of expenditure. This is a task that the region’s finance ministers are unaccustomed to performing and which will demand an unprecedented exercise in “fiscal gymnastics.”

Inside the tunnel, to cover the health emergency, make transfers to households, and support firms, governments will have to reduce or postpone other expenditures, including public investment, procurement of goods and other nonessential areas, extending even to unpopular measures such as a temporary reduction of public sector salaries, as seven of the region’s countries have already done. Such reallocations are difficult and may be politically thorny, but they are essential.

But the gymnastics do not end there. After leaving the tunnel and once the emergencies of the pandemic have receded, countries will have to meet social demands—through generous programs providing more coverage for the most vulnerable. Given the need to boost growth, for example, they will need to spend more and better on infrastructure. The pressures to continue to significantly reallocate expenditures will not cease.

Limiting Losses Inside the Tunnel: Strengthening the Health Sector

Inside the tunnel, the first battle that countries must wage is tackling the pandemic. As Blackman et al. (2020) and Pagés et al. (2020) conclude, the danger of COVID-19 will be reduced with a vaccine, but details about its availability and effectiveness are still uncertain. To lower the death rate, countries must continue to strengthen health sector capacity. The other important lesson from those authors, however, is that economic recovery depends on success in this task: demand and supply will continue to be low while fear of the virus remains high. The best economic stimulus that governments can give their countries is to be found, therefore, in the health sector.

When reallocating expenditures to address the immediate health crisis, governments must also develop the health system to facilitate the transition from general lockdown to targeted lockdown. To meet immediate demands for health care, governments must find resources to prepare hospital infrastructure and procure respirators and personal protective equipment (PPE) for health professionals. To relax lockdowns, which is key for economic recovery—the return of foreign tourists, of workers to their workplaces, of patrons to restaurants—governments must finance mass testing and contact tracing systems, with all the restrictions and challenges that this implies for the region’s countries. The risk of infection and its impact on demand and supply closely correspond to each country’s capacity to use these tools to maintain low rates of infection.

The effectiveness of health sector policies and the speed of the economic recovery also depend on people’s behavior and their attitudes toward risk. Social distancing, mandatory use of face masks, and self-isolation, among other fundamental measures, depend on citizen cooperation. Therefore, knowledge of behavioral economics must guide the policies, and the way they are communicated.

The importance of communication will remain once countries exit the pandemic tunnel, when the world will be riskier than before, especially while a vaccine is still unavailable and the population has not acquired herd immunity. The pace of economic recovery will thus depend on how people respond to these risks and whether they take steps to reduce them. Governments have an important role to play in disseminating information that enables citizens to get a real appreciation of the risks and encourages them to obey regulations to control them.

See Blackman, Ibañez, Izquierdo, Keefer, Moreira, Schady, and Serebrisky (2020) and Pagés, Aclan, Alfonso, Arroyo, Irigoyen, Mejia, Mendieta, Moreno, Muente, Peñaherrera, Pombo, Regalia, Savedoff, Stein, and Tejerina (2020). This is where tensions in fiscal policy management become immediately evident, given that, in addition to the additional expenditure on health, immediate transfers must also be made to poor and informal households and to support firms, etc. All these policies are analyzed in much greater detail in Blackman et al. (2020), which addresses the policies in the initial stages of the fight against COVID-19, and in Pagés et al. (2020), which discusses the options for relaxing targeted quarantine.

Well-structured and reliable information campaigns are especially important in times of crisis: People’s beliefs are formed on the basis of the information they receive which, during the pandemic, has been intense, sensationalist, confusing and of uneven quality. In contrast, public health campaigns, backed by scientific evidence, that explain the costs of infectious disease and the benefits of being vaccinated will increase knowledge about the disease. It is essential that governments correct erroneous perceptions, but they can only do so insofar as the public has confidence in their messages. See Park (2018) and Paek et al. (2008).
Emerging from the Pandemic Tunnel with Faster Growth and Greater Equity
Limiting Losses: Maintaining the Productive Base of the Economy

Every bankrupt firm and every lost job is a loss for the affected families and for society as a whole. In the case of many firms, especially in the formal sector, unemployment and bankruptcy have broader impacts, damaging prospects for economic recovery by destroying the intangible capital that supports high productivity.\footnote{See Fujita and Moscarini (2017) and Jacobson, LaLonde, and Sullivan (1993).}

In the most productive firms, workers have deep and tacit knowledge of the clients’ needs, plant machinery and how to operate it in a variety of circumstances, the characteristics and advantages of firm products, and the qualities of different suppliers. In those firms, workers and owners trust each other, which makes for efficient business process arrangements, such as delegating authority to workers. This intangible capital is difficult to replace. However, firms that experience a long period with low or non-existent revenues, with little ability to predict how long it will last, have no other option than to lay off workers. Firms that, in the recovery period, seek out their redundant workers after a prolonged separation may find that they are no longer available.

Likewise, firms—especially the most productive ones—enjoy the trust of clients, suppliers, and banks. This is also intangible capital that is difficult to reproduce in the event of bankruptcy. Although a bankrupt firm’s physical assets may move to new owners, the bankruptcy process is cumbersome and subject to losses, and much more so in LAC than in advanced economies. The closure of productive firms, as well as the redundancy of workers with human capital specific to these firms, therefore represents a permanent loss in economic activity and productivity.\footnote{See Foster, Haltiwanger, and Syverson (2016).}

To maintain the productive base of the economy while still inside the tunnel, countries have two classes of options: fiscal measures, such as transfers to the health sector, transfers to the most vulnerable households, employment subsidies, and tax moratoria; and financial measures, including credit guarantees to firms, whose effectiveness depends in part on the fiscal situation, and loosening the financial regulations that impede negotiations between banks and borrowers.
Fiscal Measures

Countries with ample fiscal space have various options to limit the loss of the intangible capital embedded in the relationships between firms and workers. One is the policy chosen by numerous countries (e.g., Denmark, France, and New Zealand) of providing subsidies of up to 80 percent of salaries to firms that suffered sharp declines in revenues compared to the previous year (e.g., 30 percent or more). These programs sustain the firm-labor relationship while the economy remains frozen, and they permit a rapid recovery when demand begins to return. The programs are expensive, but the costs are offset by lower payments of the generous unemployment benefits in these countries. Workers retained under the program do not receive the unemployment benefits that they otherwise would. Similar programs would have a larger net fiscal impact in LAC, since the region lacks such well-funded and wide-ranging unemployment benefit programs.

Nonetheless, although the region’s fiscal situation is not promising for employment subsidies, conditions in the region open up possibilities for targeted programs that do not exist in other parts of the world. One is to target employment subsidies only to the most productive firms, such as those that maintain a minimum level of business tax contributions, those with a minimum number of workers contributing to the social security regime (which is also an indication of productivity), and those that satisfy conditions of solvency prior to the crisis. Only firms able to demonstrate a decline in sales above a certain threshold should receive these subsidies.

Another way of providing subsidies to productive formal employment is to declare a moratorium on the payment of social charges. This would have little fiscal impact because the deferrals would be recovered after the pandemic, or the benefits that correspond to the social charges would be reduced in proportion to the deferrals. Furthermore, a moratorium on social charges could be seen as a first step toward a more fundamental reform that fosters the creation of productive employment via lower labor costs.

Like all policies aimed at tackling the crisis, employment subsidies, even when targeted, confront significant tradeoffs. For example, transfers that finance the preservation of formal employment compete with transfers that countries employ to soften the social impact of the crisis. Figure 4 shows the job losses and firm closures reported by a nonrepresentative sample of thousands of households that answered the IDB/Cornell Coronavirus Survey (2020) in 17 countries in the region. It yields three staggering conclusions: more than half of the households report that someone in the household has lost their job, just under half of those who were the owners of firms had to close them down, and the impact is much greater in lower-income households: 70 percent of lower-income households report the loss of at least one job, compared to 30 percent of higher-income households.18

This latter point is tremendously important, since the proportion of households without a single formal worker is usually two or even three times higher in the lower-income quintile than in the higher-income quintile. Every transfer that seeks to save productive/formal jobs reduces the fiscal resources needed to soften the impact of the pandemic on the most vulnerable and informal households.19 The trend in the region has been to resolve that tension in favor of immediate social needs. Therefore, very few countries have announced direct subsidies for formal employment, and, until now, only six countries (Colombia, Costa Rica, Guatemala, Panama, Peru, and Uruguay) have declared moratoria on the payment of social security contributions.20

18 See Bottan, Hoffmann, and Vera-Cossio (2020); Bonavida Foschiatti, and Gasparini (2020); and Mongey and Weinberg (2020).
19 The pandemic’s unequal impact calls for transfer mechanisms for informal households during the general quarantine, a matter that is dealt with in detail in the previous IDB report, Blackman et al (2020).
20 Internal data from the IDB “Summary of the Main Economic, Monetary and Financial Policy Measures Taken in the Face of the Global Pandemic COVID-19” (14 May 2020).
Financial Measures

Although employment subsidies are effective in limiting losses of intangible capital among workers and firms, enabling an accelerated economic recovery, their fiscal cost is prohibitive for many countries in the region. Furthermore, employment subsidies do not directly sustain intangible capital in firms, which is lost in those productive firms that, because of the crisis, have less access to credit and confront severe liquidity problems. To complement measures with direct fiscal impact and to preserve intangible capital outside of labor relations, countries can resort to financial measures.

These measures consist of loan and guarantee programs that respond not only to the difficult situation faced by firms, but also to banks’ tendency to limit risk in times of crisis. Commercial banks were well capitalized before the pandemic: on average, the capital-to-risk weighted asset ratio was 16 percent, well above the 8 percent minimum required by Basel II. Despite this, bank behavior in the face of risk tends to be pro-cyclical: in times of recession, when both the demand for loans and credit risk are highest, banks reduce credit activity. Through this reduction, banks seek to conserve their capital when faced with a probable wave of nonrecoverable loans. During the current crisis, LAC credit markets are already showing signs that the impact will be worse than in previous crises. For example, according to data released by Colombia’s Financial Superintendency, total credit provision to the private sector in Colombia fell by 50 percent between the weeks of March 9 to 13 and April 13 to 17.

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21 See Herrera (2020) for more detailed discussion with updated financial sector statistics.
22 See Nuguer and Powell (2020).
23 In previous episodes of systemic crisis, the banks’ past-due portfolio increased sharply: +20 percent in 2000/01 and +25 percent in 2008/09. However, in both cases the increase was temporary and was eventually reverted. At the same time, the increase in provision for irrecoverable loans lagged slightly behind: +15 percent in 2004, and +11 percent in 2011 (Herrera 2020).
24 See: https://www.superfinanciera.gov.co/publicacion/60829. The calculation was made by Marc Hofstetter of the University of the Andes: https://twitter.com/mahofste/status/1253716969502707187?ref_src=twsrc%5Etfw
To prevent the financial sector from becoming an aggravating factor in the economic crisis, countries can take measures while still in the tunnel and at the tunnel exit. The objective must be to encourage the financial sector to lend despite its risk aversion and to assist firms and households in mitigating the impact of the shock within prudent margins to preserve financial stability. This means backing lending operations and interest rate subsidies with central bank guarantees, as well as regulatory adjustments.

As with fiscal measures to limit economic losses inside the tunnel, credit programs must be targeted. Although the guarantee and loan programs do not have a direct impact on a country’s fiscal situation, countries with less stable fiscal policies have fewer possibilities to finance loans and provide collateral guarantees. Banks place less value on the guarantees of governments with less stable fiscal policies and are therefore less willing to lend against them. News is already circulating in the region of firms that are eligible for the guarantee programs but are denied requests for credit.

What should the criteria be for targeting credit programs? There are two dimensions: sector-based and cross-cutting. At the sector level, liquidity challenges caused by the crisis are sharper in some sectors than in others. Among them, there are some that suffer from liquidity, rather than solvency, problems and that also play an essential role in the life of the country. Two of them are the agriculture sector and the education sector. Although these are not highly productive sectors in most countries, they are crucial and the pandemic has hit them hard. In the agriculture sector, surveys carried out by the IDB of observers on the ground and producers reveal that, because of liquidity restrictions, small and medium-sized producers might not be able to plant their crops. Of the observers surveyed, 50 percent fear that the liquidity crisis might threaten the food supply.

In education, the crisis has also unleashed an uncharacteristic problem. In the region’s large cities, a high percentage of pupils attend private schools—up to 50 percent in Lima, for example. With the closure of schools and the dramatic declines in household income and ability to pay, many private schools are on the verge of bankruptcy. Their permanent closure would have dramatic repercussions on education since public schools lack the capacity to absorb those pupils when schools finally reopen.

There are also cross-cutting criteria that should be applied to credit programs. If the goal of governments is to make use of these loans and guarantees to save intangible capital and thereby accelerate growth both inside and outside of the tunnel, the ideal situation would be to target them to the most productive firms, depending on the scale of their revenue losses, their formality, and their tax record. If the goal is to soften the social and immediate impact of the crisis, the scant loan guarantee capacity could be channeled toward the firms most affected by the crisis and with the most jobs, whatever their level of productivity. Just as they have done with their subsidy policies, the region’s governments have opted for the latter option. In contrast with advanced economies, which are offering wide-ranging guarantees to all kinds of firms, the 16 countries of the region with loan and guarantee programs are directing them toward small and medium-sized enterprises, which tend to be less productive.

Financial market regulations can also exacerbate losses inside the tunnel and jeopardize economic recovery by destroying the tangible and intangible capital of the firms that go bankrupt. Bankruptcy proceedings in the region take, on average, 2.9 years, twice as long as in advanced economies.

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A more efficient way of reaching the informal sector is through household transfers.
Furthermore, the costs associated with these proceedings can reach 17 percent of the firms’ wealth, almost double the 9 percent in advanced countries. These losses directly hamper the reactivation of these firms and economic recovery. The proceedings also threaten the stability of the payments system: the debt recovery rate at the end of the process is only 30 cents on the dollar, less than half that of advanced countries and insufficient to maintain the solvency of the system if the number of bankruptcies increases exponentially.26

There are three regulatory options available to prevent the liquidity problems that arise during the pandemic from becoming, due to the region’s cumbersome and costly bankruptcy proceedings, a significant brake on economic recovery:

- Make the management of bankruptcy more agile, if only for a limited time.
- Temporarily adjust banks’ regulatory standards to persuade them to offer temporary relief, such as extending maturities, avoiding costly arrears and defaults.27 Central banks can support these efforts by granting guarantees to certain extraordinary loans or operations.
- When arrears are spreading throughout credit markets, the authorities can consider temporary moratoria or debt relief, employing the central bank balance sheet as backing.28 This is, however, a last resort. Fairness criteria should be applied to allocate losses between borrowers and lenders, with maximum transparency. The impact of forced renegotiation of financial contracts can lead to the destruction of savings, as occurred at the end of the financial crisis in Argentina in 2002.29

Limiting Losses: Education

It is difficult to overstate the costs of the prolonged closure of educational institutions. In all the countries of the region, with the exception of Nicaragua, schools closed midway through March 2020 and, even under the most optimistic scenarios, children and young people will end up losing months of in-person education, with significant negative consequences for them, for equity and for sustained growth. Making up for lost time in their acquisition of human capital is key: research into previous, less lengthy closures has shown that the salaries earned by the students affected were significantly lower when they entered the labor market.30

The impact of school closures under COVID-19 will, without a doubt, be worse. It is probable that this unprecedented shutdown will precipitate school dropouts, in particular among young people in low- or medium-income families, leading to a continuous erosion of human capital in the future.31 Furthermore, upon emerging from the tunnel, countries are also likely to experience a massive increase in demand for public sector education as soon as classes resume—an increase that the public sector will be in no position to absorb.32 On the one hand, private schools, which serve a high proportion of students in LAC countries, particularly in urban areas, face a high risk of permanent closure.33 On the other, falling family incomes during the crisis will lower the demand for private education.

26 See Herrera (2020).
27 Herrera (2020) presents a taxonomy of possible instruments.
28 Nuguer and Powell (2020), in Chapter 3, further develop this point.
29 Cavallo and Serebrisky (2016).
30 In Argentina, where the schools were closed due to a wave of teachers strikes, research indicates that children who miss the most school days learn less and eventually become less productive and earn less than they might have done. See Jaume and Willén (2019).
31 The pandemic differs from other macroeconomic crises, which gave rise to increases in school registration rates. See Ferreira and Schady (2009). In those contexts, schools were not closed and registering was a better option for the young people whose job opportunities had disappeared. In the current context, when schools eventually reopen after a closure of long duration, many youth will have lost their connection with the school, will have more available work opportunities, and will feel more pressure to compensate for the sharp losses in income suffered by their families.
32 For example, if half of all private schools in Lima were to close permanently, and the students cross over to the public system, this would imply a 50 percent increase in the pupil-teacher ratio in the public school system.
33 In Lima, for example, this figure rises to more than half of all registered pupils and in other cities, such as Bogotá, Buenos Aires, and Quito, to more than a third. See Elacqua, Iribarren, and Santos (2018).
The challenge facing public policy, therefore, is not only to recover sharp losses of human capital during the crisis, but also to impede further severe losses in the future. Other losses of human capital are indirect, but no less dramatic. Especially in poor communities, the teachers help identify children suffering from health and nutrition problems or abuse and to alert the corresponding authorities. All these problems are growing. Due to school closures, however, they remain invisible.

The region’s countries have fewer options than wealthier countries to limit the loss of human capital while the crisis lasts. For example, only Uruguay currently has digital platforms that cover the school curriculum and enable teachers to monitor their students’ progress. While school closures are prolonged, and children and young people begin to feel that their connection to their school has been broken, interventions could be developed to enable teachers to remain connected to their students (for example, through WhatsApp). To prevent the private school system from collapsing, education authorities should rapidly collect information about the number of schools and higher education institutions that close. There are two options for these institutions. One is to implement a rescue plan, targeted to schools that meet certain quality and financial standards. A second, more comprehensive option is to establish demand-side (vouchers) or supply-side (salaries) subsidy programs, but only for those schools that meet minimum quality standards and financial conditions.

Limiting Losses: Infrastructure

Public services have suffered sharp declines in income during the crisis, with implications for both their liquidity and the quality of the services they provide. The gravest impact has been on public transportation. The number of passengers using public transportation fell by more than 80 percent in the region’s megacities: Bogotá, Buenos Aires, Mexico City, Lima, Santiago, and Sao Paulo.

These declines in demand generate short-term liquidity problems, which can then become solvency problems. Public transportation is the service with the greatest risk of insolvency. The fear of infection due to physical proximity means that users will choose other means of transportation (mainly private vehicles). This effect, added to the need to maintain the supply of services to permit social distancing, will cause financial problems for public transportation service providers which, if not rapidly addressed, will require firms to rethink both their funding and the scale of their operations.

In LAC, 80 percent of the funding for operating costs of public transportation comes from fares and 20 percent from government subsidies. It is likely that, post-COVID-19, this ratio will change, and governments will have to increase permanent subsidies to the sector by a significant amount. Increasing the subsidy ratio to 50 percent is equivalent to directing approximately US$35 billion (a figure close to 0.5 percent of regional GDP) to cover operating costs.

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This is clearly impossible, given the other numerous fiscal demands that governments must meet. Other indirect subsidy options, such as loans granted by public institutions and commercial loan guarantees, are more feasible, but the financial space for them is limited.

Other services have also been significantly impacted. The demand for electricity and water fell: although domestic household demand rose, industrial and commercial demand has fallen even further due to the restrictions imposed on production. The impact on revenues for service provider firms has been exacerbated by the tariff structure, which is lower for households. The decision of many governments to defer payment of household utility bills and to prohibit service disconnection is adding to the financial problems of service providers.

In the short term, inside the tunnel, governments will have to rethink the expenditure structure of utilities and other public service firms and consider once again whether payment moratorium policies are appropriate or rather whether it would be better to target such policies to the neediest households. The small number of countries with fiscal space could temporarily and partially increase the subsidies they grant to the firms, which could later be removed as the economic recovery accelerates.
Emerging from the tunnel depends on when the health crisis is controlled—an effective vaccine is introduced, or countries have created sufficient capacity for testing, contact tracing, and isolating those infected so as to credibly lower the risk of infection to a minimum. The region will undoubtedly leave the tunnel poorer than when it entered, with more unemployment, inequality, and social unrest and greater fiscal instability. Even with an increase in spending of only 2.7 percent of GDP—the average increase announced in the region to respond to the pandemic—and the expected fall in tax revenues, average public debt could reach 73 percent of GDP by 2022. Furthermore, the patterns of globalization on which the region has depended will be different. Therefore, the imperative to spur growth will be enormous.

If the region does not grow faster and does not do more to reach the neediest sectors than it did when it entered the tunnel, it will be difficult for it to sustain a new equilibrium that supports both higher borrowing and greater social demands. These demands are neither theoretical nor inconsequential. In a region that entered the pandemic tunnel with more inequality than any other except Africa and that was already experiencing outbreaks of social unrest in the months before the crisis, the unequal impact of the pandemic is particularly problematic.

Experience with natural and financial disasters—and the pandemic has characteristics of both—underscores the importance of social cohesion for both inclusive growth and economic resilience. In the majority of the countries that have suffered the worst natural disasters, there was no impact on their per capita income after 10 years. But in those that experienced widespread social unrest, the losses were severe: they ended the period with incomes more than 28 percentage points below the level where they would have been without the disaster. Despite its importance, accelerating inclusive growth is no easy goal. The region not only entered the tunnel lagging significantly behind the advanced economies in terms of growth and inequality, but also exhibited equally significant gaps with respect to the public policies and institutions that are key for inclusive growth, ranging from the social and the fiscal to the regulatory. Figure 5 summarizes in general terms the differences seen the region, based on aggregate and global measurements from the Worldwide Governance Indicators (World Bank, 2018).

39 In those countries with the strongest democratic political institutions, and where the checks and balances of power were maintained throughout the crisis, recovery from the financial crisis was faster. See Cavallo and Cavallo (2010). Also, Tommasi (2004).

40 Disasters with a number of deaths per million persons that placed them in the top 1 percent of deadliest disasters. See Cavallo, Galiani, Noy, and Pantano (2013). In this regard, this coincides with evidence that emerges from financial crises and armed conflicts. See Mueller, Piemontese, and Tapsoba (2017).
The worse is corruption and the weaker the rule of law, the more difficult and unequal is economic growth; the lower is regulatory quality, the fewer the social benefits of regulation and the greater its negative consequences for economic activity. The figure shows the difference between the OECD countries (excluding those of LAC) and all LAC countries. The more negative the difference, the better the institutional framework of the OECD relative to LAC. It is noticeable that the gap is significant—between 1 and 2 points on a scale of 5 points—and its size has remained constant or has even grown wider.

**FIGURE 5: Institutional Performance, LAC countries versus OECD Countries (the more negative the value, the greater the gap with OECD countries)**

![Graph showing institutional performance](image)

**SOURCE:** Authors’ elaboration, based on data from World Bank (2018).

**NOTES:** The figure presents the difference in the average between the group of LAC countries and the group of OECD countries, excluding LAC members, for the variables Control of Corruption, Regulatory Quality, and Rule of Law for the period between 2002 and 2018. A negative difference implies that the LAC average is below the OECD average, for example, that its regulatory quality is worse.

**OECD** (excluding Latin America and the Caribbean): Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Estonia, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Slovakia, Slovenia, Sweden, Switzerland, and the United Kingdom.

**LATIN AMERICA AND THE CARIBBEAN:** Argentina, Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Suriname, Trinidad and Tobago, Uruguay, and Venezuela.

It impossible for the countries of the region to correct these distortions at the stroke of a pen. But neither is it possible to narrow the gaps in income and inequality that the pandemic itself has opened up unless it makes progress in reforming some of them.
A series of reform options is set out below. For the three reasons mentioned before, the options go far beyond the fiscal stimuli the region is accustomed to using to accelerate recovery from economic crisis. One is that the fall in demand caused by the pandemic responds less to fiscal stimuli: the fear of infection limits their effectiveness while, after this fear has abated, fiscal stimulus will in any case be less necessary. Another is that the region will continue to have very limited or no capacity to boost demand through fiscal stimuli. Third, there is an urgent need to achieve sustained growth that goes beyond the short-term effects of such stimuli.

The reforms have a dual benefit. First, although they are more complex than fiscal stimulus and need time to be implemented, once established they will stimulate growth quickly by removing barriers to economic activity and improving worker productivity. A second benefit is that they give the region’s countries greater access to capital markets, which, upon observing the reforms, will have more confidence in the countries’ future capacity to meet their financial obligations. Therefore, although the effects of these policies will be felt upon exiting the tunnel, it is important that their design and implementation commences while still inside the tunnel. This is in any case an ideal moment for initiating the reforms, since public support is more likely given the emergency situation.

What Should Be Done in the Short Term?

It is already clear that economic recovery depends to a large degree on public health. If the high rates of infection persist and consumers and workers continue to worry about health risks, then both demand and supply will languish at low levels. Hence, the most important aspect of expenditure reallocation is to favor those line items that reduce the risk of infection, supporting both public sector measures—mass testing, contact tracing—and private sector measures—organization of customer care and of workplaces to lower the risks of infection.

Without doubt, the greatest possible stimulus for economies battered by the pandemic shock will be new therapies, vaccines, and techniques to live with the virus, which substantially lower risk and prevent hospitals from being overwhelmed.

Among the reform options, some will take more time than others to implement and deliver the fruits of faster growth. This subset of policies—exhibiting rapid implementation and quick impact—is important because the collapse of investment, a clear symptom of the crisis, can take years to recover. The average fall in investment in emerging countries caused by a financial crisis is nearly 35 percent, and two years after the crisis only a third of this shortfall has been made up spontaneously. Therefore, policies that stimulate investment, both public and private, will be essential.

The public sector could take the first step, once the worst of the pandemic is over, by strongly reallocating spending toward public investment. Recent research indicates that public investment has the highest multiplier effect, particularly when the capital stock is low, and can reach a value of two in certain cases of low capital stock, where every additional dollar invested in infrastructure can generate up to two dollars of GDP. Furthermore, in spite of the scant available information, there are indications that the construction of infrastructure assets in LAC could create 40,000 jobs for every billion dollars spent, although the number of jobs depends greatly on the type of asset. A significant fraction of the jobs in infrastructure construction requires only low skills, thereby benefiting lower-income sectors.

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41 Countries with superior institutional quality can reach the income levels of richer countries twice as quickly as the countries with institutions of only average quality, and they also enjoy better access to capital markets. See Gupta, Mati, and Baldacci (2008) and Keefer and Knack (1997). The better the institutions, the higher the quality and quantity of entrepreneurial activities. See Chowdhury, Audretsch, and Belitski (2018). Good institutions also make countries more resilient to future disasters. In countries in which institutions demand accountability, investment in preparing for future disasters is higher, which leads to greater resilience and significantly less mortality. See Anbarci, Escaleras, and Register (2005).

43 Izquierdo et al. (2019).
44 Schwartz et al. (2009).
When considerable resources are reallocated to infrastructure, it is important to direct them to investments in sustainable infrastructure that, if well-designed, has at least as large an impact on growth and poverty as standard infrastructure.\footnote{See Cavallo, Powell, and Serebrisky (2020).} Sustainability represents a key part of the economic recovery strategy of many advanced economies that are grappling with the pandemic (China, Germany, and South Korea).\footnote{These countries pay special attention to the need to encourage, or at least not hamper, decarbonization. See Hammer and Hallegatte (2020); Koty (2020); UN (2020); and Vetter (2020).} Recent work indicates that green building projects, such as refurbishing existing buildings for better heat insulation and/or clean energy infrastructure, have high multiplier effects and are extremely labor-intensive. And critically, they lower the costs of transitioning toward renewable energies.\footnote{See Hepburn et al. (2020).}

The additional challenge that governments face is how to encourage private investment, including foreign direct investment. To respond to this challenge, governments must rapidly lower the costs of starting up an economic activity—a particular priority given the region's scant capacity to adopt policies that stimulate demand. There are three fronts on which countries can quickly take action to increase investment and private sector economic activity: financial, regulatory, and employment.

On the financial front, governments should make the regulations governing business liquidations more flexible and efficient, and support loans for new investments while, at the same time, temporarily relaxing banking supervision rules in order to encourage banks to lend.

In the regulatory sphere, barriers to entry by new firms should be tackled quickly, beginning by setting up offices at the center of government to accelerate the identification and repeal of obsolete regulations and to encourage competition, both in the private sector and in public sector contracting. Tariff policy could also be overhauled, reducing tariffs on imports of capital goods and, within an appropriate regulatory framework, relaxing restrictions on the movement of profits and dividends out of the country.

But the employment front is perhaps the most important, given the critical levels of unemployment that the region's countries will face upon exiting the tunnel and the high barriers to entry that public policy has placed on new, productive job creation. This can be achieved immediately through policies for newly hired employees, which include reducing redundancy pay, benefits, and social charges. This topic will be covered in more detail below, given that even deeper labor market reforms will be a significant factor for medium- and long-term growth.

Efforts must also be made to encourage service sector demand, which has been hit badly by the pandemic crisis. New knowledge of behavioral economics should be exploited through communication campaigns to achieve greater voluntary compliance with minimum public health standards and to correct potentially exaggerated perceptions of risk with respect to consuming services, as in the case of public transport, tourism, and food services, among others. This will also demand new thinking around the logistics of these sectors.

The pandemic crisis has accelerated the provision of digital services, such as home deliveries of products ordered online and online professional consultations. These can become a new source of expansion and employment, but will also require better digital infrastructure.
Emerging from the Pandemic Tunnel with Faster Growth and Greater Equity

Reforms for Inclusive Long-term Growth: A Menu of Options

Short-term, fast-acting reforms will be insufficient to achieve rates of inclusive growth faster than those that prevailed before entering the tunnel. They may not be enough to narrow either the gaps opened by the pandemic itself nor other, pre-existing gaps, such as climate change and environmental degradation. Countries will therefore have to think about wider and deeper reforms. What matters here is not that all of them be undertaken or completed while countries are still inside the tunnel. The key is to give clear and credible signals that identify priority reforms and to take both concrete and symbolic steps to drive them forward.

Reforms to Ensure that Expenditure Promotes Inclusive Growth

The section describing how to limit losses from the pandemic emphasized the need for significant fiscal gymnastics with regard to spending allocation, to redirect funds to urgent expenditures. After emerging from the tunnel, the fiscal situation will be different: tax revenues will rise, health sector needs will be different, and many of the most vulnerable households will have managed to find sources of income. Nonetheless, the region will continue with only limited and expensive access to the financial markets. New fiscal pressures will emerge and countries will need to do more to respond to them than reallocating expenditures. In addition, they will need to shore up their fiscal capacities with new policies and institutions that permit greater efficiency and effectiveness.

One of the pressures will be to reverse the losses that were unavoidable inside the tunnel, such as those caused by the suspension of in-person education, and that have very significant effects on both equity and growth. A further pressure will be to maintain the more expansive social safety nets that were built up during the pandemic, which before the crisis consisted of relatively small transfers with limited coverage. A third pressure will be to better prepare the health sector to face future health emergencies—and not only these emergencies, but also those, increasingly frequent, caused by climate change. Finally, there will be pressure to accelerate growth, by allocating funds to sectors with a strong multiplier effect, such as infrastructure.

Are these different goals compatible or mutually exclusive? Countries will be less obliged to choose between them if they take advantage of the period inside the tunnel to make their policies and fiscal institutions fairer and more efficient. For example, three classes of inefficient spending together add up to an average of 4.4 percent of GDP: the payment of transfers to those who are ineligible; higher salaries in the public sector than in the private sector for the same skill level, especially for jobs in lower grades; and losses in public procurement. These represent an enormous source of funding for higher priority expenditures.48

The region’s pension systems are also a source of inefficiency and inequity. In some countries, they threaten fiscal stability, leading to high interest rates and thereby putting a brake on growth. In several of the region’s countries, spending on pensions as a percentage of GDP exceeds by a significant margin what might be expected given their low rates of dependency. In other countries, where pensions cover a limited group of formal workers, pension systems exacerbate inequality. In general, pension systems in the region do little to reduce inequality. In LAC, the Gini coefficient calculated using market income is nearly the same as the Gini calculated using market income plus pensions; in OECD countries, in contrast, inequality falls by 24 percent when pensions are taken into account.49

49 Ibid.
Correcting these inefficiencies would enable the region to eliminate the heavy biases against productive expenditure, such as spending on infrastructure, and equitable expenditure, such as health and social protection. Sufficient knowledge and adequate roadmaps are available to guide swift implementation of any of these reforms. The section below outlines some sector-based reforms in education and infrastructure to strengthen the impact of spending on inclusive growth in these sectors. Cross-cutting reform options include the following:

1. Technological advances mean that a dramatic transformation of public procurement of goods and infrastructure is feasible and can bring significant savings. Nevertheless, such a transformation will fail if reform does not avoid and eliminate the many exceptions that undermine procurement reform. For example, in competitive bidding procurement systems, digital portals already exist for transactions, but many purchases are not included in them and these exceptions are neither monitored nor controlled.

2. Restructure the civil service pay system to better align it with the labor market and with public sector needs in this new era. This can be done gradually, beginning with new recruitment, taking into account the sensitivities that surround this issue.

3. Improve transfer program targeting, but, once more, proceeding gradually, increasing transfers and coverage for the better-targeted programs and minimizing increases (for example, those linked to inflation) for the less well targeted.50

4. Reform pension systems. Such reforms can proceed at the pace most suited to each country, from more gradual to more aggressive, freeing resources in the same proportion. Again, like every reform aimed at orienting public spending toward inclusive growth, this is a sensitive issue. However, Brazil has shown that, despite such sensitivity, reform is possible, having achieved a pension reform with savings equivalent to 13 percent of GDP over the next ten years. Furthermore, this is a good example of policies that elicited an immediate favorable reaction from financial markets even though the savings will only be realized in the future.

5. Institutionalize the capacity to draft budgets oriented toward inclusive growth. Centers of government throughout the region exhibit significant shortcomings in their capacity to analyze and prioritize expenditures in terms of their contributions to social goals such as equity and growth. This challenge could be met by setting up agencies with responsibility for resource allocation, which would monitor expenditure quality.

6. Equity and growth are not the only appropriate aims of fiscal policy. Also significant are national goals regarding climate change. When discussing the reallocation of expenditures for greater efficiency and equity, reducing subsidies for fossil fuel consumption in the region, which amount to 1 percent of GDP annually, represents a significant opportunity. The opportunity is even greater in times like these, in which oil prices have plummeted. Savings made from reducing subsidies can be channeled toward higher social transfers for the most vulnerable households.51

Reforms to Ensure that Tax Policy Promotes Inclusive Growth

The other pillar of fiscal policy is taxation, currently an obstacle to inclusive growth in the region. Structural biases make tax systems of the region more regressive and inefficient: tax collection depends on extraordinary degree on consumption taxes and relies little on income or real estate taxes. Beyond issues related to the overall structure of tax systems, governments also make large tax expenditures through tax exemptions and special tax regimes that support

50 This is the case of benefit leakage to the non-poor in non-contributory pensions, conditional transfers, energy expenditure, and tax expenditures on food, medicines, and housing, whose rates of leakage range from 43 percent in the case of social assistance spending (non-contributory pensions and conditional transfers), to 81 percent in energy expenditure, and 84 percent in tax expenditures on food, medicines, and housing. See the upcoming report by Busso and Messina (2020).

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neither growth nor equity. Even when these exemptions seem to have equitable goals—such as, for example, VAT exemptions for basic foods, medication and rents—they lead to heavy losses in tax revenues and channel most of their benefits toward the wealthiest people, the ones who spend the most. Other exemptions and special regimes for income and other taxes favor those in the highest income brackets even more. Furthermore, (as discussed below) high employment taxes also lead to massive inefficiencies and inequities in the labor market and the structure of the economy.

Reforms of tax systems are both feasible and effective: they can improve efficiency and equity. Mexico completed a successful reform, mostly by levying higher taxes on corporate profits and by reducing income tax deductions. The tax reform implemented by Costa Rica in 2018, focused on the treatment of salaries, rents, financial market, remittances, profits, surpluses, and capital gains, was structured so that 80 percent of revenue generated by the reform would be paid by the 20 percent of high-income households and firms. Simple policy changes that eliminate generalized tax exemptions and at the same time provide income transfers only to low-income households would generate significant savings.

As with expenditure reforms, tax reforms can proceed gradually, beginning when countries emerge from the tunnel to avoid interference with the recovery, but giving a clear signal of continuous changes in the future—ideally via legislation—in such a way that both sustainability and investor confidence are protected.

Reforms to Reduce the Barriers to Productive Job Creation

Productive firms are the drivers of economic recovery: they create the productive jobs that are key for inclusive growth. LAC entered the pandemic crisis hampered by barriers to the activities of these firms, including a wide range of public policy distortions that specifically discourage productive job creation. The consequence of these distortions is clearly seen in the region's high informality rates, a condition that affects one out of every two workers. Only the most productive firms can afford to pay formal job creation costs, giving rise to significant gaps in both salaries and productivity between them and the large number of informal firms in the region.52

Employment regulations, special tax regimes, and other distortions discourage formality: the non-salary costs of hiring a formal worker can as much as double the average salary of an informal worker. Above and beyond these non-salary costs of job creation, special tax regimes impose significantly higher taxes on firms with employee numbers above a certain threshold, which are often the most productive firms.53 Such distortions lead to the proliferation of small and non-productive firms. Economic recovery after emerging from the tunnel will be slow and unfair unless governments begin to address these distortions.54

There are two main factors that obstruct productive job creation and, therefore, growth and inequality reduction. Both are problematic and difficult, but there are clear roadmaps for reforms that take their sensitivity into account and chart a gradual pace of reform.

One is the fragmentary nature of social protection regimes, which discourages formality. Formal workers enjoy benefits such as health insurance and pension rights, financed by payroll taxes, that amount to as much as 47 percent of the cost of the average salary.55 However, many workers do not value the benefits of the contributory system in consonance with the taxes they have to pay to receive them. Hence, these systems discourage formal job creation.56 Several of

52 See Busso, Fazio, and Levy Algazi (2012) and Messina and Silva (2019).
53 Alaimo et al. (2017).
54 The evidence shows that reducing informality contributed significantly to the fall in equality in the region during the first two decades of the twenty-first century. By reverse logic, given that informality is certain to increase after emerging from the tunnel, it is to be expected that inequality will rise again through this channel. Messina and Silva (2018).
55 Alaimo et al. (2017). Payroll taxes vary widely, in a range that goes from approximately 10 percent of the average salary in Honduras and Trinidad and Tobago, to 47 percent in Argentina.
56 Some reasons why this might happen: formal employees must contribute for a minimum number of years in order to receive a pension, while workers in households with one formal worker already have access to the benefits of formality without being formal themselves.
the region’s countries have also developed a non-contributory social protection pillar, financed through general taxes and not linked to employment. This discourages participation in the formal system since households can receive some of the benefits of formal work without making contributions. Thus, reducing taxes in the labor market and financing social protection through general taxes can help to reduce this distortion by reducing informality and improving equity in the receipt of social security benefits.\(^57\)

The second barrier to formality consists of the high redundancy costs prevalent in the formal sector, which also deter firms from hiring formal workers. These costs are the sum of the redundancy payments—between 5 and 15 percent of the average salary—and of the high uncertainty and transaction costs related to the possible litigation this regulation may cause.\(^58\)

To eliminate this barrier to productive job creation, the options are as follows:

1. Establish, while still inside the tunnel, *emergency formal contracts* with lower redundancy payments and lower non-salary costs. These contracts would offer fewer rights than the usual formal contract, but more than the probable alternative in a period of stagnation: an informal contract with no rights at all.

2. Inside the tunnel or at the tunnel exit, reduce the uncertainty surrounding formal hiring by establishing a clear pathway to increasing rights and remuneration over time, until the new desired level is reached, which is *lower than the current one*. The key to achieving equity and growth goals is ensuring there are no major differences in the non-salary costs of formal and informal jobs.

3. Establish a clear pathway to reducing special tax regime employment thresholds to zero.

4. Begin to reform the protections offered to formal workers. Since the new emergency contract undermines employment protection, at least initially, countries should gradually expand unemployment protection systems if they already exist, or begin to develop new systems if these are lacking.

Finally, the creation of productive jobs requires reform of active employment policies. Training programs in the region are scarce and, when they do exist, are often of short duration and focused on the most vulnerable young people.\(^59\) Some informal workers will need support to gain a place in the formal sector. This gap can be covered by active employment policies that, if well-designed and with a significant component offering internships in firms, can be effective.\(^60\) Remediation policies are also needed, which might include, for example, registers with better information about job offers and job seeker characteristics, to improve the chances of matching workers with firms.

**Economic Recovery: Reducing Barriers to Creating Productive Firms**

In all markets—product, work, capital—there are high regulatory costs that hamper the creation of productive firms and, therefore, of productive jobs, much more than in advanced economies. These are numerous and varied, and coordinated government initiatives dedicated to dismantling them must therefore be established to foster short-term growth.

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57 See Levy (2020).
58 Alaimo et al. (2017) and Heckman and Pagés (2000).
59 Busso et al. (2017).
60 Busso, Cristia, and Messina (2020).
The OECD data offer a perspective on the barriers to entry that form an important part of the regulatory obstacles to economic activity in LAC. Its data take into account a wide array of regulations that hamper the entry of firms and competition between firms, ranging from requirements to get authorization before starting economic activities and price controls, to rules that impede participation in public procurement. The stiffer the barriers, the fewer the opportunities for all to participate in the economy, and the greater the possibilities for monopolistic and, in the employment market, monopsonistic behavior. Such barriers reduce competition and, therefore, innovation and growth.61

The OECD-monitored regulations are a convenient and feasible starting point from which to begin redirecting government policies toward productive firm creation. Reforming these regulations can begin inside the tunnel with a coordinated effort at the center of government.

As Figure 6 shows, the gaps between the region and the advanced economies with respect to these barriers are significant and have widened since the 2008–2009 economic crisis. The gap between LAC and the OECD in product market regulation (which averages out the gaps in domestic and foreign barriers to entry and state control) is higher than 10 percent (.65 on a scale of 6 points), a difference that, furthermore, has not narrowed in the two decades between 1998 and 2018. In fact, it has even widened slightly.62 Governments could begin to close the gap in the following way:

1. An announcement of regulatory measures to narrow the gaps with the OECD and a commitment to equal the OECD averages with regard to barriers to entry.
2. The creation of an office at the center of government, responsible for achieving this objective.
3. A review, by the same office, of all government regulatory proposals.

Subnational governments in many countries play an important role in fostering economic activity, with regulatory authority ranging from access to land to public safety. These countries could consider adopting a practice that is common elsewhere, of establishing a competitiveness rating for each subnational region of its regulatory environment for business creation.

Reforms that Reduce Barriers to Financing for Productive Firms

Just as the region entered the tunnel with public policies that made productive job creation more costly, it also entered with policies that hampered access to the capital needed to finance job creation. Whereas banking credit to the private sector in the United States averaged nearly 200 percent of GDP before the pandemic, in a typical country of the region it failed to reach 50 percent, and only in Chile did credit exceed 100 percent of GDP (World Bank, 2019a). Figure 7 shows that this situation has hardly improved in recent years: since the cusp of the 2008 financial crisis, credit to the private sector as a percentage of GDP, relative to the same measure for advanced countries, only rose from 30 to 40 percent in LAC, whereas in Asian countries, even starting from a much higher figure, it rose much more, from 75 to 105 percent. On top of the scarcity of credit, relatively few firms receive credit and access is highly inequitable.63 In some countries, less than 5 percent of firms (formal and informal) have access to credit, whereas in other emerging countries the figure surpasses 30 percent.64

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62 There is 1 LAC country in the 1998 and 2003 samples, whereas there are 3 countries in 2008, 18 in 2013, and 5 in 2018.
63 Herrera (2020).
64 Nuguer and Powell (2020).
FIGURE 6: Barriers to Entry in LAC versus the OECD (the more positive the value, the greater the barriers to entry in LAC versus the OECD)

**Source:** Authors’ elaboration based on OECD and World Bank (2018).

**Notes:** The figure presents the average difference between the LAC and OECD countries (excluding members of LAC) for the product market regulation (PMR) indicators. If the difference is positive, the barriers to entry in LAC are more severe than those in the OECD (that is, its product market regulation is stricter). Product market regulation is the aggregate indicator that results from the state control and domestic and foreign barriers to entry indicators. The difference between the two groups for each available year (the OECD has been calculating the indicator every five years since 1998) is represented graphically. Given that data availability for each year varies greatly, the composition of the groups also varies over time (details below).


Upon emerging from the tunnel, access to credit will be even more difficult. It is likely that banks’ delinquent loans will increase more than in past crises and, therefore, the funds set aside for nonrecoverable loans will have to be even greater than before. In that context, the region’s banks, which have traditionally been conservative in their attitude toward risk, will be inclined to defend their capital ratios to maintain solvency. Credit to the private sector might therefore contract still further, hampering economic recovery.

Responding to the credit challenge will call for regulatory and liquidity measures that respond to the current circumstances, but also for more fundamental corrections that reduce the significant barriers to credit that existed prior to the pandemic. These will be even more important since, in many cases, countries will have used up their capacity to use short-term fiscal tools to stimulate investment.
The immediate options that countries have upon exiting the tunnel are basically the same as those available while still in the tunnel and for dealing with the pandemic:

1. Regulatory standards should be temporarily adjusted to allow banks some extra room for maneuver with their borrowers, for example, by waiving regulatory penalties associated with maturity extensions.

2. Avoid forced renegotiation of financial contracts, inside and outside of the tunnel, given its destructive effects on savings and lending, as occurred at the end of Argentina’s financial crisis in 2002.

3. Central bank guarantees for credit operations, and loan interest rate subsidies.

4. Liquidity injections into the financial system through monetary and fiscal sources, and the development of new credit instruments enabling banks to assist firms in these circumstances.

5. Depending on the situation in each country, banking supervisors should persuade banks to preserve existing lines of credit and to develop new instruments for the crisis, encouraging them to use the capital and liquidity reserves they maintain for emergency cases, such as the current one.

Beyond immediate measures, other reforms can correct the fundamental distortions that plagued credit markets in the region before the pandemic. One such distortion is economic instability, meaning that all recommendations made in the above sections with regard to fiscal policy and the crisis are of special importance: instability reduces the volume of credit and raises its cost.

The second distortion is the lack of information. In many countries, financial intermediaries lack good-quality information about potential borrowers and respond by charging more to cover their risk. The rules that determine the scope, accessibility, and quality of the credit information available through public or private credit records means that such information is shared less in LAC than in advanced regions, a situation that has not noticeably improved in recent years.

A third is the uncertainty surrounding compliance with financial contracts. Herein lies the importance of avoiding forced renegotiation of such contracts. Effective protection of financial contractual rights in the region is negligible, according to comparative data from the World Bank Doing Business database. Figure 8 reveals a significant gap with advanced economies in this respect. The region began to narrow the gap with OECD countries between 2013 and 2015, but progress stalled from that year on, while the gap with Asia widened.

65 This analysis closely follows and updates the discussion in Chapter 11 of Cavallo and Serebrisky (2016).
66 The World Bank Doing Business report (2019c) contains an index that measures the scope of credit information on a scale of 0 to 8. The average value for LAC is 5.1, while it is 6.8 for the OECD countries.
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**Figure 8**: Strength of Credit Contracts Index (relative to OECD values)

<table>
<thead>
<tr>
<th>Year</th>
<th>East Asia and the Pacific</th>
<th>Latin America and the Caribbean</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>0.50</td>
<td>0.75</td>
</tr>
<tr>
<td>2014</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>2015</td>
<td>1.25</td>
<td>1.25</td>
</tr>
<tr>
<td>2016</td>
<td>1.25</td>
<td>1.25</td>
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<tr>
<td>2017</td>
<td>1.25</td>
<td>1.25</td>
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<tr>
<td>2018</td>
<td>1.25</td>
<td>1.25</td>
</tr>
<tr>
<td>2019</td>
<td>1.25</td>
<td>1.25</td>
</tr>
</tbody>
</table>

**Source**: World Bank (2019b).

**Notes**: The figure presents the ratio of the strength of the legal rights of credit contracts between LAC and OECD regions, and Asia and OECD countries. Values below one indicate that rights in a region are weaker than in the OECD. In its original source, it is called the Strength of Legal Rights index, and it measures the degree to which collateral and bankruptcy laws protect the rights of both borrowers and lenders and, therefore, facilitate lending. The index ranges from 0 to 12, and the highest scores indicate that these laws are better designed to extend access to credit.

The options for a sustained reduction in the costs of credit address these challenges.

1. Accelerate the opening of credit bureaus, and reform the legal framework to enhance the storage and exchange of credit information.
2. Accelerate bankruptcy proceedings, perhaps by prolonging the emergency processes detailed above for actions taken while still inside the tunnel.
3. Facilitate the entry of new credit agencies that have found non-institutional—for example, digital—solutions to the problems of information and compliance. The greatest potential for reducing the costs of credit may lie in digital tools, such as Fintech, that have the potential to prevent bottlenecks in traditional credit markets. Their widespread adoption will depend on a series of conditions, both technological and legal.67

Reforms to Reverse Losses in Human Capital and Make Spending on Education More Efficient

Inside the tunnel, the region will experience three major setbacks: nearly all children will have lost some months of in-person education; many of them will have dropped out and will never return to school; and many private schools will have closed permanently. Reversing these losses is a priority—even more so in schools that serve poor children, who have suffered more during the crisis and who also entered the tunnel having experienced the consequences of major spending disparities between richer and poorer pupils.68 But merely spending more will not be sufficient: the region entered the crisis lagging significantly behind the advanced economies. This raises doubts about its capacity to narrow the gaps with the scant resources available, unless teaching can be made more efficient and effective.

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67 Herrera (2020).
68 It is possible to reduce these disparities: over the last 20 years, the distribution of expenditure on education in Chile has become more progressive, although within a context of substantial increases in total expenditure. See Elacqua, Montt, and Santos (2013).
One way of looking at these gaps is by comparing LAC performance in international PISA tests with those of OECD countries (excluding countries from the LAC region). The differences are significant: on average, the scores of pupils from the wealthiest quintile of LAC in mathematics, language, and science tests are similar to those of pupils in the poorest quintile of the OECD countries. In LAC, 65 percent of pupils who take the mathematics test fail to reach minimum skill levels; this proportion is just 24 percent in the OECD. Furthermore, the performance gap between LAC and OECD has narrowed only marginally over the last 15 years. Figure 9 shows that the region has serious performance deficits in PISA tests even when controlling for per capita income levels.

**FIGURE 9**: Programme for International Student Assessment (PISA) Results in Mathematics and Per Capita GDP

The options for the region, both the most immediate and those that seek to address the deeper problems of education in the region, are the following:

1. Extend the school year when schools have reopened, or temporarily extend the school day.
2. As the negative effects of the crisis on learning will in all certainty be greater for poor children, create targeted tutorial programs either in schools or for children from low-income families.
3. To reverse the school dropout rate, after emerging from the tunnel, conditional cash transfer programs should be strengthened, targeting them toward the age groups most at risk from school dropout (middle- or middle-higher education students). There is robust evidence that such transfers reduce school dropout rates.\(^69\)
4. Establish a subsidized loan program, accompanied by quality monitoring measures, which would enable private schools to reopen.
5. Apply new standards and incentives for *future* teachers, to improve teaching quality, in particular the quality of teachers who give classes to disadvantaged children.\(^70\)

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\(^69\) See Fiszbein and Schady (2009) and many later studies.
\(^70\) The impact of teachers on learning varies considerably, including significant differences among teachers at the same school (Caridad Araujo et al., 2016). On average, however, the quality of teachers in rural and poor areas is worse than that of their peers in urban and higher-income areas. There is a clear roadmap for im-
Reforms to Strengthen the Contribution of Infrastructure

As shown earlier, public services, ranging from public transport to electricity and water, have sustained significant losses during the crisis. These will have to be reversed after emerging from the tunnel. Nonetheless, as in other areas of spending, when the region entered the tunnel it already lagged significantly in terms of infrastructure quality. The crisis will worsen infrastructure deficiencies that, even before the crisis, were hampering inclusive growth in the region. For example, 40 percent of the difference in international freight services between LAC and the OECD can be attributed to differences in infrastructure quality and the management of ports and airports (Mesquita Moreira and Stein, 2019). Unless the quality of infrastructure spending can be improved, reallocating expenditure toward infrastructure, as recommended in the above section on options for the short term, will have less impact on growth.71

As in other dimensions of public policy that are also crucial for growth and equity, the region has failed to make much progress in narrowing gaps with wealthier countries. Figure 10 reveals that, since 2008, LAC has managed to improve only slightly the quality of its infrastructure services, narrowing only a fraction of the gap with advanced economies. But it also shows that the quality gap with other regions, which in many cases are in direct competition for the export of goods, has also widened over time.

A significant explanation to help understand the backwardness observed in Figure 10 is that, for many decades, the region has invested less than other regions. While LAC invested on average 2.8 percent annually over the past decade, other regions invested much more (5.7 percent in East Asia and the Pacific; 4.8 percent in the Middle East and North Africa, and 4.3 percent in South Asia). Although a reduction in the percentage of the budget allocated to public investment is noticeable throughout the world, this trend has been stronger in LAC, falling 10.3 percent between 1980 and 2018, whereas in industrialized countries it fell only 3.6 percent.72

The gaps are also the product of the quality of expenditures. Evidence shows that advanced economies could enhance the quality of their infrastructure by approximately 10 percent with the same level of public spending, but the corresponding figure for LAC is 30 percent.73 The difference is explained by the institutional framework for public investment in the region, which permits the selection of projects with low social returns and the implementation of projects at excessive prices. An index of the quality of the institutional framework for infrastructure assigns an average value of 2.5 to LAC, where 4 is associated with high efficiency.74

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73 See Ardanaz, Briceño, and García (2019).
74 See Armendáriz et al. (2016).
To narrow the quality gaps and increase the growth impact of infrastructure investments after emerging from the tunnel, the region has the following options:

1. Adopt the institutional frameworks currently considered best practices and for which the roadmap is clear, especially by addressing the most flagrant shortcomings in infrastructure planning, evaluation, and auditing.

2. So that the institutional framework identifies, prioritizes, and implements projects with the highest socioeconomic return, the region’s countries should at least identify a bank of projects based on clear criteria anchored in sustained growth and equity. Incorporate digitization strategies into infrastructure plans. Introduce policies that encourage private sector adoption of digital tools, since the region’s firms are at a very low level with respect to adopting digital technologies, around a decade behind in implementation compared to Asian and European firms. These measures would bring significant economic benefits, for example, through trade.

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75 For example, the efficient movement of goods throughout the supply chain depends not only on the quality of the infrastructure, but also on the interaction between the economic actors who dispatch, transport and receive the goods. For this to become more fluid and efficient, and to mitigate the risks of supply chain disruption due to shocks such as COVID-19, policies are needed that promote the adoption of technology. These include the digitization of processes to streamline administrative procedures to counteract reduced public office timetables or closures, the rapid integration of information systems among different actors, especially those related to inventory management, and the creation of platforms and applications for goods distribution in urban areas.

76 In the search for greater efficiency, resilience, and competitiveness in the region’s supply chains, it will be essential to update technologies in the most backward links, such as land transport companies and the public sector. Policies must be amended that, at present, impede the entry and growth of transport firms with modern vehicles and technology and, in the public sector, the process of digitizing and integrating transport information processes with other administrative procedures (customs, phytosanitary services, etc.) must be accelerated via one-stop shops. See Calatayud and Katz (2019).

77 See Mesquita Moreira (2013) and Volpe Martinicus (2016).
3. Decisively target new infrastructure investments to achieve sustainability and resilience targets, which are also determinants of sustained growth. Infrastructure has a long-term impact on both the environment and climate change.

Reforms to Strengthen the Role of International Trade as a Driver of Growth

According to the World Trade Organization’s most optimistic estimates, the fall in world trade following the outbreak will surpass the “great trade collapse” that resulted from the 2008–09 financial crisis (Figure 11). Having faced severe economic crises in the past, governments have found it hard to resist the temptation to erect trade barriers to “protect jobs.” In the current crisis, this temptation has been reinforced by misleading public health arguments, which has led to increased restrictions on the export of medical products (Figure 12). These trends undermine one of the few opportunities available to accelerate economic recovery: barrier-free international trade. International trade offers at least three significant opportunities: nearshoring, the recovery of the Asian markets, and import substitution.

The trade war and health crisis is causing a drastic reevaluation of the risks of concentrating suppliers in far-off countries, some of which have opaque institutional and regulatory frameworks. This reevaluation increases the incentives for nearshoring and creates significant opportunities for foreign direct investment and exports in the hemisphere.

Another valuable opportunity for recovery comes from the fact that the main markets are in different phases of the epidemiological cycle. This is particularly the case of Asia, and especially China, which is already in full recovery mode and is often among LAC’s main markets (for example, Brazil’s exports to China grew by an inter-annual rate of 23 percent in April, following a sharp fall in the first trimester).

**FIGURE 11: LAC Exports in Times of Crisis: The Great Recession and the Health Crisis**

**SOURCES:** Authors’ elaboration with data from the IMF World Economic Outlook and OMC and based on Baldwin and Evenett (2020).
The third and final opportunity arises from the sharp currency devaluations experienced by various LAC economies (e.g., Brazil, Mexico, Colombia, Chile, and Uruguay) since the start of the crisis, which can encourage domestic investments to compete with imports (for example, medicines and medical equipment). How can LAC countries take advantage of these opportunities as they emerge from the tunnel? The following are some of the policy options:

1. In terms of health, trade should be free from tariffs and non-tariff barriers to strengthen the supply of medical products and reduce their costs. The recent initiative by Chile and six other countries (Australia, Brunei, Canada, New Zealand, Singapore, and Myanmar), which committed to refraining from imposing restrictive measures on the trade of essential goods—especially medicines—raises hopes that this is not only a desirable path, but also one that could be replicated elsewhere.

2. Exploiting opportunities for nearshoring and the recovery of Asian markets requires measures that reduce trade costs, rather than the opposite. These include administrative and regulatory measures that immediately lower the costs of logistics (for example, eliminating restrictions on the activities of international cargo operators) and of customs procedures (for example, expanding programs for authorized economic operators and digital single windows). To create opportunities for import substitution, reducing tariffs, especially on capital and intermediate goods, can be important. This would lower investment costs and accelerate access to frontier technologies. It would also stimulate nearshoring.

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78 As Baldwin and Evenett (2020) show, these restrictions are far from being a solution for the current or future health crises, since they ignore the reality that these products depend on a wide and complex global supply chain, which has helped to reduce the cost and dramatically expand the supply of medicines. It is likely that countries would have been even less prepared to respond if the restrictions that have since emerged had existed before the crisis. Should the restrictions persist, countries will have increasingly fewer possibilities of tackling the current crisis, because they do not produce all the goods in the chain and they will have provoked retaliation that exacerbates scarcity, drives up costs, and discourages investment.

3. To exploit nearshoring opportunities, the region should leverage preferential agreements that already exist in the hemisphere, above all with the United States and Canada. Relaxation and harmonization of rules of origin in these agreements, permitting the accumulation of inputs from third countries, would also help boost these investments. Expanding access to the Asian market must also be a priority: efforts must be made to expand the network of trade agreements with the region, which, at the moment, is restricted to just a few LAC countries. For example, only Chile, Costa Rica, Panama, and Peru have free trade agreements with China.

4. Going forward, the priority must be to preserve and strengthen the multilateral rule-based trading system. At the regional level, an incomplete agenda could be revived—one that permits the extension and convergence of the more than 33 existing preferential agreements. This is particularly important given the current crisis and uncertainty in world markets. Recent IDB estimates indicate that this agenda could expand intraregional trade by 11.6 percent, an opportunity that the region is in no position to forego, especially if world trade integration tends to fall in the coming years.80

In the national sphere, countries that maintain high levels of protection could provide a significant boost to economic growth by seeking convergence with OECD levels of openness, through a combination of unilateral and preferential liberalization initiatives. As a recent IDB study revealed, the so-called Great Liberalization of trade at the end of the 1980s was decisive in overcoming the stagnation then seen in the region, accelerating average growth of per capita income from 0.6 to 0.7 percent per year.81

80 Mesquita Moreira and Stein (2019).
81 Ibid.
Emerging from the Pandemic Tunnel with Faster Growth and Greater Equity
Conclusions: Reforms with a New Social Compact

Despite the health emergencies they face, countries must remain aware that, in moments of crisis, possibilities arise for promoting economic and social policies that prioritize the interests of society as a whole. The reforms mentioned in the above sections will be essential for accelerating post-pandemic growth and ensuring it is both inclusive and sustainable.

Taken together, these reforms represent a new social compact that aims at sustainable economic growth, with benefits widely shared throughout the entire society, and with more inclusive social protection coverage for the people most vulnerable to shocks. If this new compact is to materialize, governments must make their promise of greater equity and faster growth believable. Moreover, once it is in place, countries will be better positioned to tackle the challenges of a new world: the growing threats of climate change, de-globalization, the digitization gap between the region and the advanced economies, and others outside the scope of this report, such as the waves of migrants seeking refuge, and environmental degradation.

Prior to the crisis, trust in the region’s institutions and governments was already low and in decline, prompted by discontent with a social compact that has been seen as regressive for decades. The social cracks are widening and support for democracy is weakening. However difficult it may be, the social compact will have to be rethought to embrace greater opportunities and more comprehensive social protection networks, including:

- More formal job opportunities and formal firms.
- Good-quality services that reach those who have less (health, education, security).
- Networks that protect workers against temporary shocks (unemployment insurance).
- Networks that reach informal workers and the vulnerable middle classes, even including the possibility of universal health coverage.
The new social compact is not only economic. It reflects a commitment to altering governance in the region to solve the problems of society as a whole, rather than of certain groups to the detriment of the rest. A compact that offers more opportunities and, at the same time, signals greater social protection, will strengthen the political will needed to carry out the reforms. Such a compact is no utopian dream: it is clear that, at this moment, LAC countries have far fewer options than in the previous crisis. The COVID-19 crisis will be more severe than the 1998 crisis, which affected only the developing world, and worse than the Great Recession of 2008–2009, during which the region was better positioned in terms of fiscal firepower. Raising awareness of the sheer scale of this crisis can increase perceptions of the need for significant changes, as actually happened during and after the Great Depression of the 1920s and 1930s. Those who make the right decisions today will certainly find access to financing, which is scarce at the moment, easier. Furthermore, the better the response to the pandemic—the more people and firms that are protected—the greater the support there will be for deeper reforms. In this sense, a well-managed crisis presents an enormous opportunity for countries to renew the social compact to achieve more inclusive growth, with more economic opportunities for all.
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References


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Appendix

Further notes for Figure 5

The Control of Corruption index (Figure 5) of the Worldwide Governance Indicators (World Bank, 2018) captures perceptions on the degree to which public power is used to obtain private benefits, including both minor and major forms of corruption, as well as state capture by elites and private interests. It is a standardized variable that takes values between 2.5 and −2.5, where the higher value represents greater control of corruption.

The Regulatory Quality index of the Worldwide Governance Indicators (World Bank, 2018) captures perceptions of government capacity to formulate and apply solid policies and regulations that permit and promote private sector development. It is a standardized variable that takes values between 2.5 and −2.5, where the higher value represents greater control of corruption.

The Rule of Law index of the Worldwide Governance Indicators (World Bank, 2018) captures perceptions regarding the degree to which agents trust and respect the rules of society, specifically the quality of the execution of contracts, property rights, the police, and the courts, as well as the probability that crimes and acts of violence are committed. It is a standardized variable that takes values between 2.5 and −2.5, where the higher value signifies compliance with the law.

Further notes for Figure 6

In addition to the effort carried out by the OECD every five years, an estimate was made together with the World Bank for 15 LAC countries using the methodology employed between 1998 and 2013. The LAC countries with available information for the years between 2013 and 2018 are included in the average for 2013, because this is the closest comparable methodology, and therefore it permits a point of comparison to this group of countries.

The PMR aggregate indicator is the simple average of two indicators: (i) State Control and (ii) Foreign and Domestic Barriers to Entry. PMR is an indicator that takes values from 0 to 6, where 0 is least restrictive and 6 is most restrictive (indicators (i) and (ii) take the same values). The indicator (i) is general performance with respect to control of the government/state in the product market, and (ii) is the simple average between two indicators that measure general performance in relation to the barriers to business initiative in the product markets and general results in relation to barriers to trade and investment in the product market. The methodology between 1993 and 1998 calculated three major estimates and aggregated them to calculate the PMR, but for the purposes of making the results comparable with the data for 2018, it is reduced to two indicators by aggregating domestic and foreign barriers into a single one.
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