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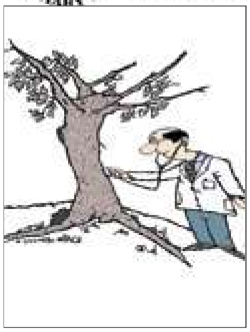

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Getting the Diagnosis Right

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A new approach to economic reform

During the past 15 years, there has been a tremendous focus on achieving growth in developing countries in an effort to reduce poverty and boost living standards. To help them achieve this goal, many countries have adopted the policies known collectively as the Washington Consensus—the enforcement of property rights, maintenance of macroeconomic stability, integration with the world economy, and creation of a sound business environment. Results have been extraordinarily varied. In fact, what the experience of the past 15 years has shown is that policies that work wonders in one place may have weak, unintended, or negative effects in other places.

In this article, we propose a new approach to reform—one that is much more contingent on the economic environment. Countries, we argue, need to figure out the one or *two most binding constraints* on their economies and then focus on lifting those. Presented with a laundry list of needed reforms, policymakers have either tried to fix all of the problems at once or started with reforms that were not crucial to their country's growth potential. And, more often than not, reforms have gotten in each other's way, with reform in one area creating unanticipated distortions in another area. By focusing on the one area that represents the biggest hurdle to growth, countries will be more likely to achieve success from their reform efforts.

We propose a decision tree methodology to help identify the relevant binding constraints for each country. While our methodology does not specifically identify the political costs and benefits of various reform strategies, its focus on alternative hypotheses will help clarify the options available to policymakers for responding to political constraints. We are concerned mainly with *short-run* constraints. In this sense, our focus is on igniting growth and identifying constraints that inevitably emerge as an economy expands, not on anticipating *tomorrow's* constraints on growth.

We demonstrate how this approach would work through case studies of Brazil, El Salvador, and the Dominican Republic. In the first two countries, policymakers sought to implement wholesale reform following international best practice during the 1990s. But the results in both countries were disappointing, with low growth throughout most of the period. The Dominican Republic also implemented reforms, but on a much more limited scale, and yet it exhibited strong growth throughout the 1990s until it was hit by a banking crisis in 2002. The Dominican Republic, as we will see, managed to find a way around the most important binding constraint on its economy with minimal reform effort, whereas Brazil and El Salvador still have not overcome the main obstacles to growth in their economies.

Drawbacks of current reform strategies

Economists define an underperforming economy as one that is characterized by rampant market distortions. Such distortions, whether government-imposed or inherent to certain markets, prevent the best use of the economy's resources, hindering its productivity and driving wedges between the value attributed to specific economic activities by society on the one hand and by individual citizens on the other. For policymakers, the challenge becomes how to maximize social welfare while taking into account standard resource constraints and the distortions prevailing in the economy. A market distortion can be thought of as a tax that reduces the equilibrium level of activity by keeping the net private return below the social return. Reducing a distortion is expected to increase aggregate welfare—the more costly the distortion, the larger the increase in welfare. And this is indeed the case when there is only one distortion—only its direct effect will matter. But when there are others, as is typical in a reforming economy, interaction effects in other areas of the economy need to be tracked. If reducing a distortion also alleviates other distortions, the result will be an additional welfare benefit. But if these interactions exacerbate other existing distortions, the welfare gain is reduced. A reduction in one distortion may thus end up producing an actual welfare *loss*—a phenomenon known as second-best interactions. This is why second-best interactions are a crucial consideration for policymakers to keep in mind when designing reform strategies.

One way to eliminate uncertainties about the effects of reforms is to eliminate all distortions simultaneously. Because doing so eliminates second-best interactions, this strategy—known as *wholesale reform*—is guaranteed to improve welfare. But to implement it, the policymaker must have complete knowledge of all prevailing distortions as well as the capacity to remove them. For these reasons, though technically correct, this strategy is practically impossible to implement in real life.

A second strategy—*reform as much as possible*—is to pursue whatever reforms seem practical and politically feasible. This strategy, which seems to be the prevailing approach today, implicitly relies on the notion that any reform is good; the more areas reformed, the better; and the deeper the reform in any area, the better. But it is based on faulty economic logic. The second-best principle indicates that any given reform cannot be guaranteed to promote welfare in the presence of numerous distortions. Therefore, welfare does not necessarily increase with the number of areas reformed, and deeper reform in any area is as likely as an incremental approach to fall prey to adverse second-best interactions.

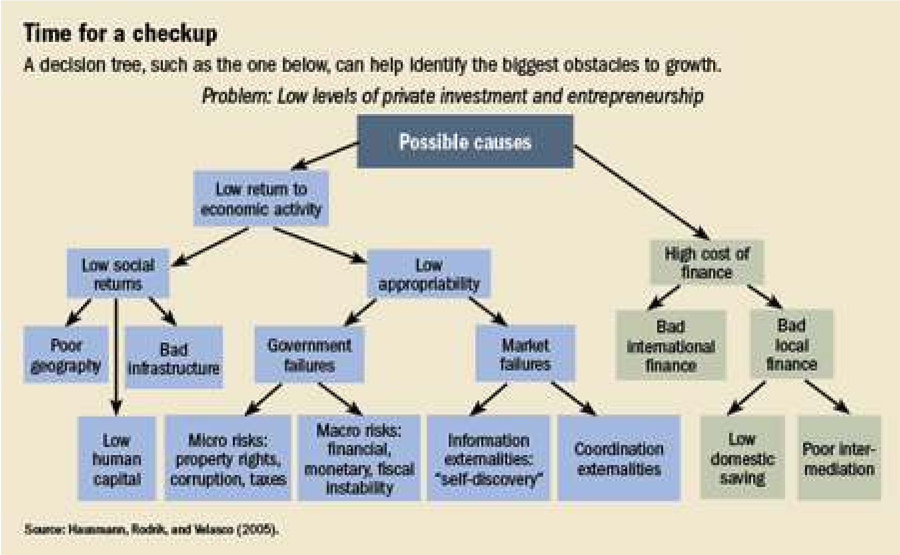
A more sophisticated version of "reform as much as possible" —*second-best reform*—focuses on reforms with positive second-best interactions and limits or avoids those reforms known to have adverse effects. But many, if not most, second-best interactions are difficult to identify prior to implementation. This strategy therefore requires a strong sense of the consequences of policy changes across different markets and activities, and the state of the art is not encouraging in this respect.

Reformers may instead focus on eliminating or reducing the biggest distortions in the economy—an approach known as *target the biggest distortions*. Under certain (fairly restrictive) conditions, this strategy can improve welfare. But it has two shortcomings. First, it requires a complete list of distortions. Second, it does not guarantee that reforms with the biggest effects on welfare and growth will be undertaken first. For these reasons, this strategy has uncertain benefits, especially in the short run.

Pinpoint the most binding constraint(s)

We advocate setting reform priorities based on the size of their direct effects. The idea behind this strategy is that, since the full list of requisite reforms is unknowable or impractical, and figuring out the second-best interactions across markets is a nearly impossible task, it is best to focus on the reforms whose direct effects are expected to be significant. The principle to be followed is simple: go for the reforms that alleviate the most binding constraints and, hence, produce the biggest bang for the reform buck. Rather than use a spray-gun approach in the hope that we will somehow hit the target, focus on the bottlenecks directly.

How can this be done? We begin with a basic but powerful taxonomy (see chart). In a low-income country, economic activity must be constrained by at least one of the following two factors: either the cost of finance is too high, or the private return to investment is too low. If the problem is with low private returns, that in turn must be due either to low economic (social) returns or to a large gap between social and private returns (what we refer to as low private appropriability). The first step in the diagnostic analysis is to figure out which of these conditions more accurately characterizes the economy in question.



Little to show for lots of reforms

For a long time, development policy focused on promoting saving and capital accumulation. The thinking was that low growth was caused by insufficient increases in factors of production, particularly physical capital. But in recent years, the focus has shifted to increasing human capital through better health and education.

Can the poor growth performance in Brazil and El Salvador be explained by low saving and too little emphasis on education? On the face of it, these two factors make a compelling argument because these countries have both low savings and investment rates and relatively low education attainment. For this story to be plausible, however, we should be able to observe high returns on capital and education. If domestic savings are scarce, high foreign debt or a large current account deficit would signal that the country is making extensive use of foreign savings. There would also be a strong willingness to remunerate domestic savings through high interest rates.

Both are true of Brazil, and its growth has, in fact, moved in tandem with the external constraint in recent years, suggesting that growth is limited by the availability of savings. But El Salvador has not come close to using up its access to foreign savings. Nor does it remunerate domestic savings at high rates. Indeed, El Salvador has the lowest lending rates in Latin America, while Brazil has the highest. Perhaps the most telling indicator that El Salvador is not constrained by a lack of savings is that a dramatic boost in remittances has not been converted into investment. This suggests that the country invests little, not because it cannot mobilize resources (though savings are low) but because it cannot find productive investments. Thus, it seems that El Salvador is a low-return country and Brazil a high-return country.

Education levels in the two countries reveal a similar contrast. If education represented a significant constraint on growth, one would expect high earnings for those few who do get educated. Average schooling of the labor force is low in both countries, but educated Brazilians enjoy some of the highest salaries in Latin America. In contrast, El Salvador is below the regional average when it comes to returns on education. Hence, weak education is not a principal source of low growth in El Salvador, but it may be a part of the story in Brazil.

The bottom line is that the challenge for El Salvador is to identify the reasons for the low returns on investment, while for Brazil it is to explain why domestic savings do not rise to exploit large returns to investment.

El Salvador: dearth of ideas. Low investment in El Salvador may be due to distortions that keep private returns low despite high social returns, particularly if social returns are not easily transferred to the individual level. Insufficient reward for individual risk taking can have many causes. The main potential ones are high taxes, macroeconomic imbalances, weak contract enforcement and property rights, and political uncertainty. Investment and growth can also be stifled by shortcomings in infrastructure, labor policy, and the exchange rate. But none of these are significant concerns in El Salvador.

Instead, the country's binding constraint is a lack of innovation and demand for investment. What we have in mind here is not innovation in the way this term is used in advanced economies. Rather, it is the ability to develop higher-productivity activities and nontraditional products that can be produced profitably at the local level. El Salvador has experienced sharp declines in its traditional sectors (cotton, coffee, sugar), but it has not been able to compensate with new ideas in other areas. The absence of such ideas explains why growth, investment, and expected returns on investment are low. A lack of "self-discovery" seems to be the binding constraint on El Salvador's growth. Encouraging more entrepreneurship and the development of new business opportunities should therefore be at the center of its development strategy.

Brazil: too many ideas, not enough money. In contrast, Brazil has more ideas than it has funds to invest. Although the country suffers from an inadequate business environment, a low supply of infrastructure, high taxes, high prices for public services, weak contract enforcement and property rights, and inadequate education, our framework discards them as reform priorities. If these factors represented significant constraints on growth, they should depress investment by keeping private returns low—and yet private returns on investment are high in Brazil. Investment is instead constrained by the country's inability to mobilize enough domestic and foreign savings to finance investment at reasonable rates.

An improvement in Brazil's business environment would make investment even more attractive. But it would not address the savings problem, thus exacerbating the binding constraint—a lack of available capital for investment. This example demonstrates why reforms that may seem to enhance growth—lowering taxes, reducing public sector prices, and improving infrastructure and education—could lower public savings and end up having the opposite effect.

Brazil has been trying to cope with the paucity of domestic savings by both attempting to attract foreign savings and remunerating domestic savings at very high real rates. Over time, the country has borrowed so much from abroad that it has been perceived as being on the brink of bankruptcy. When that external constraint is relaxed and more capital becomes available—say, because of an increase in the general appetite for emerging market risk or because of higher commodity prices, as has happened recently—the economy is able to grow. But when the external constraint tightens, real interest rates increase, the currency depreciates, and growth declines.

This scenario suggests that the underlying problem is the conflict between the large demand for investment and inadequate domestic savings. A more sustained relaxation of the constraint on growth would therefore involve increasing the domestic savings rate. However, this is easier said than done. Brazil's share of public revenue, at 34 percent of GDP, is by far the highest in Latin America and one of the highest in the developing world. Yet public savings have been negative, and, despite high (and distortionary) taxes, Brazil's fiscal balance is precarious. High taxes and low savings reflect high spending and social transfers and reduce the disposable income of the formal private sector. Resources are not used to increase public savings, and the positive effect that high interest rates may have on private savings is offset by their negative effect on public savings because they increase the cost of servicing public debt. High taxes and negative savings also reflect high entitlements, waste, and a large inherited debt. This setup forces the country to choose among high taxes, high public sector prices, low investment in infrastructure, and low subsidies for human capital.

All of these things are bad for growth because they depress private returns to capital. Yet returns are high, and investment is constrained mainly by a lack of funds. If high taxes and limited public goods were the binding constraint, private returns on investment would be low and the equilibrium between savings and investment would occur at a lower return to capital. This distinction is important because it goes to the heart of whether reform should emphasize policies to encourage aggregate savings (for instance, fiscal consolidation) or private returns (for instance, lower taxes).

So what should Brazil focus on? It could increase national savings by reducing government entitlements and waste. The direct effect would be higher aggregate savings, lower interest rates, better public debt dynamics, and lower intermediation margins, as well as a potentially positive effect on foreign savings. Lowering the burden of pensions through social security reform may be an effective way to achieve this. But such measures may not be politically feasible at this time.

In the absence of this first-best policy, the question is whether a progrowth strategy can instead be based on an apparently antigrowth set of measures, such as higher taxes and public prices, and lower infrastructure and human capital subsidies. Our analysis suggests that it can. The microeconomic inefficiencies of high taxes and suboptimal spending are not binding because reducing these inefficiencies would increase returns to capital but would not generate the means to exploit new investment opportunities. If the country can move to a faster growth path and if waste does not grow with GDP, it may outgrow its burdens and gradually improve its tax and spending system as fiscal resources become more abundant. In this respect, Brazil's current strategy, which emphasizes fiscal consolidation and reducing public debt, may be the best way to go, despite its microeconomic inefficiencies.

A lot to show for few reforms

During the 1980s, as its sugar exports collapsed and its gold resources were exhausted, the Dominican Republic had to reinvent its economy. The country had weak institutions, and the difficulties of the 1980s wreaked havoc with its macroeconomic balance. A balance of payments crisis erupted in 1991, but the country dealt with it swiftly and accompanied it with modest structural reforms. Unification of the exchange rate and some trade liberalization triggered high growth until the 2002 banking crisis. Yet, despite financial turmoil in 2002–04, the economy did not contract as happened in financial crises in other countries. Why?

The answer seems to lie in the importance of the country's main drivers of growth: tourism, *maquila* (the assembly of imported component parts for reexportation), and remittances. All three depend on an adequate institutional framework. In particular, tourism is sensitive to problems of personal security and infrastructure, while the *maquila* sector is very sensitive to trade protectionism. Instead of solving these problems for all economic activities—a daunting task—the Dominican Republic managed to provide the appropriate public goods for these two sectors, insulating them from the problems the rest of the economy was suffering from and allowing them to flourish. Personal security and infrastructure were improved in and around the main tourist destinations, and the *maquila* sector was given special trade policy treatment. In this sense, the Dominican Republic is a good example of an alternative path to development: one that identifies sectors with high potential and then provides them with the institutions and public goods they need to thrive.

The problem with such a strategy is that the economy might outgrow its institutions, or the stakes of the political game could become so high that the political process is disrupted. Although the country's weak political and fiscal institutions did not become a problem, the financial system eventually did. Imposing prudential standards proved both politically and institutionally difficult. When the U.S. terrorist attacks of September 11, 2001, suddenly stopped international tourism, a Ponzi scheme (a special kind of pyramid scheme) in the banking system was uncovered. Managing this crisis involved converting more than 20 percent of GDP in bank losses into public debt. Domestic credit grew dramatically because the central bank had no international reserves with which to sterilize money creation, and the exchange rate depreciated dramatically, causing annual inflation to rise to more than 65 percent by June 2004.

These changes wreaked havoc with the fiscal accounts, and the country is just now pulling itself out of the crisis. Still, the moral of the story is clear: reigniting growth may not require the infinite laundry list of reforms that have become best practice. But once an economy is on a growth path, the onus is on policymakers to remove institutional and other constraints that will inevitably become more binding as the economy expands.

More effective

Because across-the-board reforms are politically difficult and have often failed to achieve growth, we have offered an approach that targets the most binding constraints. An important advantage of our framework is that it encompasses all major development strategies and clarifies when each is likely to be effective. As the discussion shows, different circumstances send different diagnostic signals. An approach to development based on these signals is likely to be much more effective than one based on a long list of institutional and governance reforms that may or may not be targeted at the most binding constraints on growth.

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