

# The Unfinished Poverty Agenda

## Why Latin America and the Caribbean Lag Behind

*Danny M. Leipziger*

Compared with East Asia, Latin America and the Caribbean have made very little progress in reducing poverty rates since the 1980s, largely because of sluggish growth.

**N**EARLY 36 percent of the population in Latin America and the Caribbean lives below the poverty line—the same proportion as a decade ago. Although incomes have gone up a little since the 1980s, the fact that one out of three inhabitants lives in poverty is not good news. Furthermore, the portion of the population living in extreme poverty climbed to 16 percent in 1997 from 13 percent in 1987. Why is the region's performance so dismal compared with that of East Asia? For quick comparison, between 1986 and 1995, Malaysia cut its poverty rate by two-thirds while Thailand's dropped by half, from 26 percent to 13 percent. The simple answer is slow growth—Latin American and Caribbean economies grew a paltry 1.3 percent a year in real per capita terms over the last decade. And this despite the region's proximity to the rapidly growing U.S. economy of the 1990s.

Indeed, the forgotten element in many current development strategies is growth. There is a new emphasis on better-targeted and more efficient safety nets and a much-needed focus on governance and equity; however, GDP growth, which has been one of the main forces driving improvements in living standards in East Asia, is weak in Latin America and the Caribbean. High-performing East Asian economies experienced an eightfold increase in per capita income between 1960 and 1995, in sharp contrast with Latin America and the Caribbean, where income per capita only doubled over the same period (Chart 1).

One tantalizing question is what would have happened had Latin America and the Caribbean grown as fast as East Asia for even one decade. In fact, the former's poverty rate would have been cut by half and the percent-

age of the population living in extreme poverty would have dropped to the low single digits. The poverty profile of Latin America and the Caribbean would have resembled that of Chile, the region's star performer.

### **Impact of growth on the poor**

Why such a powerful effect? We now have important evidence that, contrary to previous thinking, growth translates into income gains not only for the general population but for the poor as well (Dollar and Kraay, 2000). We also have evidence that income fluctuations inflict as much but no more suffering on the poor as on others, providing a strong rationale for income protection (Gil and others, 2000). There needs to be a renewed emphasis on government interventions to help the poor, particularly those living in rural pockets that lag behind even when the rest of the country is enjoying robust economic growth. But most of the poor, especially the large and growing poor populations in urban areas in Latin America and the Caribbean, will benefit more from stronger growth performance than from anything else.

Evidence from Argentina, for example, shows a strong correlation between urban poverty rates and the country's macroeconomic ups and downs: poverty rates rise during recessions, when employment opportunities dry up, and decline during economic upturns. This implies that a fair proportion of highly vulnerable households live close to the poverty line. In Latin America and the Caribbean, the "poverty gap"—the percentage of the poor's current income that would lift them above the poverty line—averaged 15 percent in 1986, rising to almost 17 percent in 1997. However,

no economy in the region has enough fiscal resources to transfer even a small fraction of this amount to the poor every year. The only solution lies in sustained higher rates of economic growth.

It is well established, theoretically and empirically, that growth is necessary for—indeed, is the foundation of—poverty reduction. Nevertheless, it bears repeating. Income inequality, as measured by traditional measures, is extreme in Latin America and the Caribbean, and there is strong pressure for increased social spending. Unfortunately, the region's fiscal capacity to finance social spending is weak. The poor are therefore unlikely to get a bigger slice of the pie

unless the pie itself grows: it would be extraordinarily difficult, if not impossible, for countries in the region to generate the resources they need for income redistribution. Finally, although there are strong economic arguments in favor of reforming labor markets to create incentives for job creation and cutting back overly generous public pensions, neither goal will be easy to pursue in the current environment of sluggish growth and lack of employment opportunities.

To highlight the importance of growth, the poverty profile of Latin America and the Caribbean was simulated using elasticities of poverty with respect to growth and inequality calculated by Wodon (2000). (Wodon's method-

## Income growth and infrastructure investment

Chart 1

While per capita income skyrocketed in Asia's newly industrialized countries during 1960–96, it only doubled in Latin America and the Caribbean.

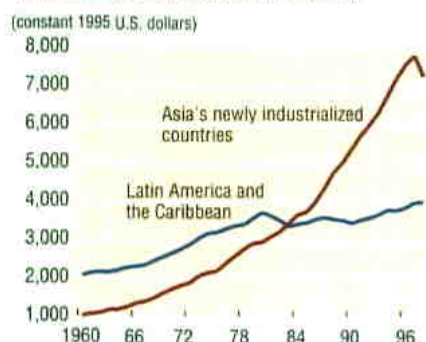


Chart 2

Actual poverty rates in Latin America and the Caribbean versus what was possible.

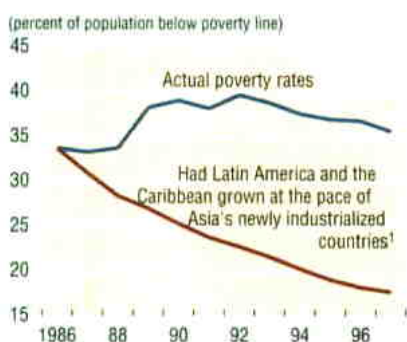


Chart 3

Infrastructure and income are closely associated in fast-growing East Asia, less so in Latin America and the Caribbean.

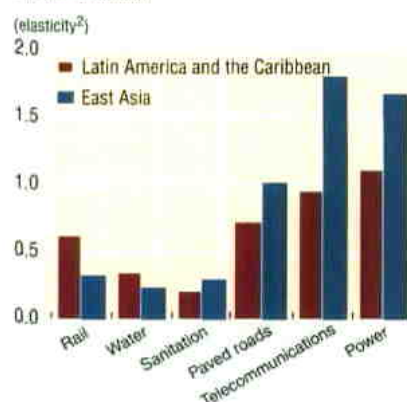


Chart 4

Private financing for infrastructure in Latin America and the Caribbean is important but not sufficient.

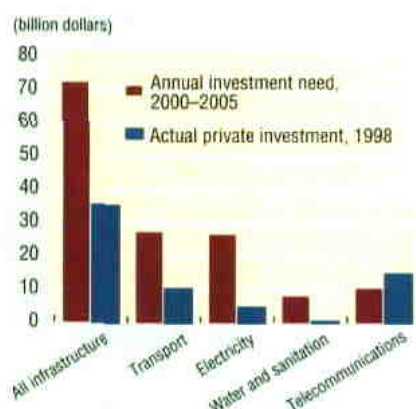


Chart 5

World Bank lending for infrastructure projects in Latin America and the Caribbean declined relative to other sectors and in absolute terms.

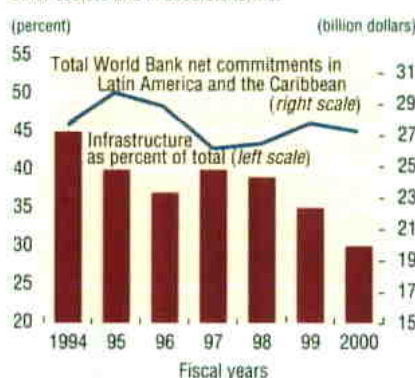
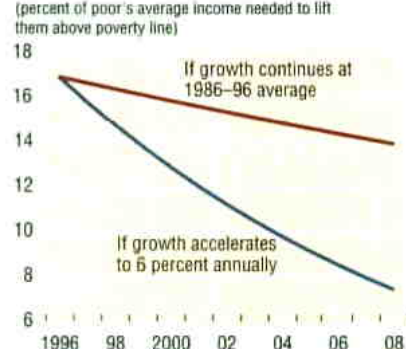


Chart 6

Strong growth in Latin America and the Caribbean could cut the poverty gap in half in a decade.



Sources: For charts 1, 2, 3, 5, and 6, World Bank. For Chart 4, data for investment need are from Fay (2000), adjusted to include rehabilitation and, for telecommunications, mobile lines. Data for actual private investment are from the World Bank's Public-Private Infrastructure Advisory Facility. All infrastructure includes gas, ports, and airports in the case of actual private investment, but not for annual investment need, which is therefore likely to be somewhat higher than \$72 billion.

<sup>1</sup> Asia's newly industrialized countries grew 5.8 percent a year, on average, during 1986–97.

<sup>2</sup> Percentage change in per capita infrastructure stock associated with a percentage change in per capita income.



ology calculates the gross elasticity of poverty with respect to growth and then, taking account of any changes in income distribution, the net elasticity as well. Income distribution in Latin America and the Caribbean was largely unchanged during 1986–96, so gross and net elasticities are virtually identical.) The counterfactual uses the growth rates registered by the highly successful East Asian dynamos for a decade (Chart 2). From 1986 to 1997, when growth rates were very modest, the average poverty rate in Latin America and the Caribbean rose to 40 percent of the population before settling at 35 percent. Very rapid growth, however, would have resulted in a dramatic decline of the poverty rate to 17 percent and a rate of extreme poverty of less than 6 percent, compared with the actual level of 16 percent recorded in 1997. The contrast is striking. So what is impeding growth in the region?

### Obstacles to growth

Saving and investment rates in Latin America and the Caribbean are well below those in Asia's newly industrialized countries, and big economies like Argentina and Brazil are less open than their Asian counterparts. This may explain why Asia outperforms Latin America and the Caribbean in both competitiveness and productivity. Moreover, Latin America and the Caribbean have a legacy of inflation that limits the region's scope for expansionary policies.

The region's focus on fiscal discipline—a key aim given past policies—and the high cost of social programs and debt service are two reasons for underinvestment in Latin America and the Caribbean's physical infrastructure. Despite a recent surge in direct investment flows to the region aimed at such sectors as telecommunications and energy, other sectors have suffered. Transport costs, for example, remain relatively high. The fact that it costs more to ship goods within the region than to ship them to Asia or the United States highlights the inadequacy of the region's infrastructure as well as the weakness of its regulatory environment.

Infrastructure in much of the region is in disrepair because of overly ambitious projects in the past, fiscal compression that hits budget items like maintenance and repair especially hard, and often ill-advised decentralization of transport networks. As Canning (1998) and others have shown, the infrastructure stock in most of Latin America and the Caribbean has deteriorated over time, limiting competitiveness and growth. Indications of this are seen in extraordi-

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narily high inventory levels—an unproductive use of capital—shown by Guasch (2001) to be two to three times the average in the Organization for Economic Cooperation and Development countries.

*Repairing and building up infrastructure* is critical for growth, as East Asia has demonstrated (Chart 3). The strong relationship between income growth and the availability of power, telecommunications, and paved roads can be seen in Latin America and the Caribbean, although it is somewhat weaker than in Asia. And access to clean water and sanitation, transportation to job sites, and electricity—which recent World Bank surveys have shown are top priorities for the poor—yield tangible welfare gains (Narayan, 2000).

Latin America and the Caribbean have sought to meet their huge infrastructure needs while shrinking the

public sector by turning to the private sector. Indeed, the region has been the recipient of substantial foreign direct investment flows. However, investors have favored three countries—Argentina, Brazil, and Chile—and private investment has been concentrated in the telecommunications and power sectors, which account for 75 percent of total investment since 1982. The region's need for infrastructure investment is so great that private sector investment alone will not be able to satisfy it (Chart 4).

The region is caught in a trap of low growth, low savings, and extraordinarily low tax revenues because of pervasive tax evasion and weak job creation in the formal economy owing to rigid labor markets. At the same time, large debt-service payments and pension obligations, together with revenue-sharing arrangements with states or provinces, can, in some countries, consume almost the entire federal budget. Many of the region's public treasuries are thus underfinanced, and there is little left over for investment.

The downward trend in infrastructure investment in the region is also seen in the World Bank's lending pattern: the share of the World Bank's portfolio in Latin America and the Caribbean dedicated to infrastructure has fallen dramatically, from 45 percent in the World Bank's fiscal year 1994 to 30 percent in fiscal year 2000, which ended on June 30, 2000 (Chart 5). Some decline is to be expected, particularly in those sectors and countries that are attractive to private investors, but the decline, especially sharp in the past few years, may have serious repercussions. In response to the financial crisis of 1998, the World Bank shifted toward quick-disbursing loans for Latin America and the Caribbean. Although the change in World Bank lending pat-



terns might be merely a temporary countercyclical response to the crisis, the abrupt shift away from lending for infrastructure investment and the sectoral policy dialogue that accompanies such lending signals another shock to the rebuilding of necessary infrastructure in the region and is at odds with the high priority given to regional infrastructure in the Brasilia Communiqué, signed by the 12 South American presidents at the Rio summit on September 1, 2000.

Another impediment to growth in Latin America and the Caribbean is the inability of the region's entrepreneurs to compete in external markets, because their access to working capital is limited and the cost of credit, very high. As a result of transport bottlenecks and insecurity of supply, raw materials inventory levels in Brazil and Chile are three and four times U.S. levels, respectively (Guasch, 2001). In addition, government, business, and labor rarely collaborate to substantially increase productivity and competitiveness. Where they have collaborated—in El Salvador and Chile, for example, through competitiveness councils—the results have been excellent. Thus, much of what has been driving growth in East Asia—a national vision supported by investment in infrastructure, exports, and access to credit—is lacking in Latin America and the Caribbean.

### Growth as primary goal

Growth should be the core of all country development strategies around which efforts to reduce poverty, broaden citizens' participation in government, and improve governance can flourish. Chart 6 shows an illustrative poverty-gap calculation under contrasting growth rate assumptions, and the outcome is telling. Were Latin America and the Caribbean to grow as fast as the newly industrialized countries in Asia for a decade, the average income transfer needed, in principle, for the poor to reach the poverty line would be 7 percent of current income, rather than 17 percent. As a matter of public policy, therefore, faster growth makes the poverty problem more manageable. (It is also important to recognize that improvements in distribution can increase the benefits of growth to the poor; these changes take time, however, and, indeed, inequality worsened in some countries in the region during 1986–96.) Sustained growth in Chile, for example, has brought with it substantial poverty reduction. And as the region's leaders themselves have pointed out, further integration and prosperity will depend on building up the physical infrastructure as well as on a renewed social consensus.



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Clearly, a sustained pro-growth strategy requires power sharing among major sectors in the economy and stronger public institutions to prevent private sector excesses (Burki and Perry, 1998). The quality of growth matters, a point driven home by Chenery (1974) and reemphasized in the broader context of governance by Thomas and others (2000). But the answer to why Latin America and the Caribbean have lagged behind East Asia with respect to poverty reduction starts squarely with growth performance. Failure to come to grips with the impediments to real sector growth could doom the region to high poverty rates for another decade. **F&D**

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