

Competing in the world economy does not automatically boost a nation's productivity and restructure its economy. Such progress requires mobilizing capital, employment, technology and knowledge. Opportunities beyond the business realm must be fully exploited to the benefit of society as a whole.

These essential strategies underlie *Competitiveness: The Business of Growth*, this year's edition of *Economic and Social Progress in Latin America*. The report offers the most complete comparison to date of indicators of competitiveness for some 20 countries in the region, including:

- International rankings of competitiveness
- Constraints to business development
- Export composition and performance
- Availability of and access to financing
- Human resources and training
- Port, electricity and telecommunications infrastructure
- Innovation and informatics
- Industrial and investment policies
- Foreign direct investment

The report provides clear policy guidelines and priorities for both government and the private sector to foster competitiveness. It identifies each country's strengths and weaknesses and proposes strategies to increase productivity and improve access by businesses to productive resources.

"Developing countries have far more potential for growth than appearances would suggest. The assets of the poor represent an enormous potential source of growth, but only if conditions exist to convert those assets into capital. This volume examines obstacles to business development that have impeded social and economic progress in Latin America. The report provides solid and statistically-supported arguments why economic growth should become Latin America's most promising 'business' in the years ahead."

Hernando de Soto, President
Institute for Liberty and Democracy
Author of *The Mystery of Capital*



INTER-AMERICAN DEVELOPMENT BANK
1300 New York Avenue, NW
Washington, DC 20577

www.iadb.org/pub

ISBN: 1-886938-96-2
ISSN: 0095-2850

Distributed by
THE JOHNS HOPKINS UNIVERSITY PRESS
Baltimore and London



COMPETITIVENESS

THE BUSINESS OF GROWTH

ECONOMIC AND SOCIAL PROGRESS IN LATIN AMERICA
2001 REPORT

COMPETITIVENESS

The Business of Growth

2001 Report

Economic and Social Progress in Latin America

Distributed by the Johns Hopkins University Press for
the Inter-American Development Bank

Washington, D.C.

Competitiveness: The Business of Growth

Economic and Social Progress in Latin America

© Copyright 2001 by the Inter-American Development Bank
1300 New York Avenue, N.W.
Washington, D.C. 20577

Distributed by
The Johns Hopkins University Press
2715 North Charles Street
Baltimore, Maryland 21218-4319

ISBN: 1-886938-96-2
ISSN: 0095-2850



Preface

Over the past decade, the countries of Latin America and the Caribbean have made great strides in modernizing their economies. Macroeconomic problems have been controlled, and mechanisms that once protected industrial sectors from foreign competition have been dismantled. The region has been a leader in reforming such sectors as electricity, telecommunications and ports, which as recently as a decade ago were reserved for the public sector. Many other forms of state interference in economic activities have been eliminated.

Despite these reforms, however, economic growth in Latin America is still not sufficient to reduce income gaps with respect to the developing world and to solve the region's problems with poverty. Although substantially better than in the 1980s, growth in the region reached an annual average of only 3.3 percent in the 1990s.

Does this mean that Latin America should abandon these efforts in order to explore a new model of development? This question is being posed by the very constituents to whom government policy must respond on a daily basis. And it is also capturing the attention of analysts and researchers throughout the continent, in-

cluding the Inter-American Development Bank. Through publications such as *Economic and Social Progress in Latin America*, the IDB aims to clarify the problems faced by countries in the region, as well as the possible options available to address them.

The causes of slow economic growth can be viewed from various social, economic and political perspectives. This Report concentrates on problems that affect the markets of principal factors of production, and on the conditions that influence the ability of businesses to efficiently use those factors. Increasing the supply and making more productive use of financial resources, physical capital, human resources and technology is at the heart of "the business of growth," which should be profitable as much for workers and for society as a whole as it is for firms themselves.

Economic growth is also the business of the Inter-American Development Bank, whose principal objective is to provide governments with the financial and technical support they need to adopt the policies that best contribute to economic and social progress. Private investment and the creation of high-productivity jobs are essential to that task.

Enrique V. Iglesias
President

Inter-American Development Bank

Acknowledgments

The Research Department of the Inter-American Development Bank was responsible for preparation of this Report. Eduardo Lora was in charge of coordination of this edition. The principal authors are as follows:

Chapters 1, 2 and 3:	Eduardo Lora
Chapter 4:	Ernesto Stein, Javier Kapsoli and Eduardo Lora
Chapters 5 and 6:	Arturo Galindo
Chapter 7:	Margaret Miller and Arturo Galindo
Chapter 8:	Tor Jansson
Chapter 9:	Carmen Pagés with Miguel Székely
Chapter 10:	Carmen Pagés and Gustavo Márquez with Miguel Székely
Chapters 11 and 13:	Alejandro Micco with Natalia Pérez
Chapter 12:	Jaime Millán with Eduardo Lora and Alejandro Micco
Chapters 14 and 15:	Alberto Chong
Chapters 16 and 17:	Alberto Melo
Chapter 18:	Ernesto Stein and Christian Daude

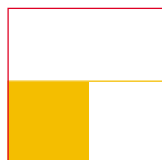
Research assistants for this Report were Patricia Cortés, Christian Daude, Javier Kapsoli, Natalia Pérez and Fernanda Ruiz. Ramón Espinasa, Ana María Herrera and José Antonio Rivas served as consultants.

We would like to thank the organizations that collaborated in compiling the databases used for the Report. The competitiveness indicators for the Latin American countries in *The Global Competitiveness Report* were compiled jointly by the World Economic Forum and the IDB. The World Business Environment Surveys were conducted by the World Bank and the IDB. ECLAC made available its technical support in the use of databases on international trade, and the Latin American Federation of Banks collaborated in conducting a survey on banking regulation.

The authors wish to acknowledge the valuable comments received from the panelists and participants in the seminars on competitiveness organized by the IDB and ECLAC as part of the Bank's Annual Meetings in Santiago, Chile in March 2001. The working papers on which this Report is based were presented there. We also thank Bank personnel who participated in internal discussion workshops on those working papers and provided comments during revisions of this Report.

Larry Hanlon and Carlos Trípodí were responsible for the translation of the respective Spanish and English versions of this Report. Mauricio Olivera was responsible for preparing the graphics and for the electronic compilation process. Editing and design were handled by the IDB Publications Section. Luisa Choy-Luy and John Dunn Smith provided additional editorial and translation support.

The opinions expressed in this Report are those of the authors and do not necessarily reflect the views of the Inter-American Development Bank or its Board of Executive Directors.



Contents

Introduction	1
Part I. Dimensions of Competitiveness	
Summary	9
Chapter 1. Growth, Productivity and Competitiveness in Latin America	11
Chapter 2. Obstacles to Business Development	27
Chapter 3. The Size of “Large” Firms	35
Chapter 4. Exports and Competitiveness	43
Part II. Financial Market Development to Promote Business Growth	
Summary	57
Chapter 5. Financial Regulation and Supervision	61
Chapter 6. Ownership and Structure of the Financial Sector	73
Chapter 7. Information in Financial Markets: The Role of Credit Registries	81
Chapter 8. Microfinance: From the Village to Wall Street?	89
Part III. The Human Factor and Competitiveness	
Summary	105
Chapter 9. Labor Costs and Competitiveness	107
Chapter 10. Removing Barriers to Improved Labor Productivity	121
Part IV. Infrastructure: The Platform for Efficiency	
Summary	147
Chapter 11. Ports and Transport	151
Chapter 12. Electricity	165
Chapter 13. Telecommunications	179
Part V. The Capacity to Innovate	
Summary	197
Chapter 14. The Promise and Challenge of Information Technologies	199
Chapter 15. The Ability to Innovate and Use New Technologies	209
Chapter 16. Innovation Systems in Latin America	219
Part VI. Industrial and Investment Policies	
Summary	237
Chapter 17. Industrial Policy at the Turn of the Century	239
Chapter 18. Foreign Direct Investment Policies	251



Introduction

Economic growth in Latin America has been disappointing. Annual growth was only 3.3 percent in the 1990s, despite a relatively benign world economic setting and the fact that many countries were posed for recovery, since their economies had stagnated or been in recession during the previous decade. The region's modest growth enabled Latin Americans to increase their average incomes by only 1.5 percent annually, less than in the developed countries, where it increased 2 percent annually, or in some groups of Asian countries, where incomes grew at rates near 3.5 percent. The rate of income growth in Latin America is so slow that it would require about a century for the region to attain the current income levels of developed nations.

Latin America is not a monolithic region, and income gaps between its richer and poorer countries are increasing as well. While in the eight wealthiest countries per capita income grew at about 2 percent annually in the 1990s, in the eight poorest countries this figure was only 0.7 percent.¹ To make matters worse, the concentration of income increased in the 1990s in practically all countries of the region, limiting the favorable impact of growth on poverty. Currently, 170 million Latin Americans—one of every three people—live on less than \$2 a day. That number would be 45 million lower if the distribution of income had been maintained without change in the 1990s. And it would be 80 million lower if, in addition, per capita income had grown by 3.5 percent annually instead of 1.5 percent.

The Problem of Competitiveness

There has been considerable interest in recent years among governments and the private sector in identify-

ing policies that can improve “competitiveness”—so defined as the quality of the environment for investment and for increasing productivity in a climate of macroeconomic stability and integration into the international economy. Strictly speaking, this is an inappropriate use of the term, since, as Paul Krugman (1994) has warned, it is businesses rather than countries that compete with one another. This confusion can make competitiveness “a dangerous obsession,” to use Krugman’s expression, because it leads to the notion that a country’s economic strength is measured by its external trade surplus, that imports are undesirable because they displace national employment, and that the low salaries of poor countries are a threat to the growth of rich countries.

The most internationally disseminated competitiveness indicator—*The Global Competitiveness Report* produced by the World Economic Forum—avoids this confusion by concentrating on the quality of the business environment. In the 2001 edition, which includes 20 Latin American economies, nine of them for the first time, competitiveness is evaluated on the basis of the quality of the macroeconomic environment, the quality of public institutions, and technological capability. According to these indicators, most Latin American economies rank very low by international comparison. Only Chile and Costa Rica are in positions above the median, while Latin American countries occupy seven of the lowest 11 positions worldwide.

Considering that the ranking in this competitiveness index tends to reflect countries’ level of development, these results should not be surprising. Nonetheless, given the income level of their economies, 10 of the 20 Latin

¹ The countries considered are the 26 members of the Inter-American Development Bank.

American economies have competitiveness indicators much lower than what would be expected. This is troubling in that the potential for future growth depends not so much on absolute positions in the index as on how favorable a country's conditions of competitiveness are in relation to its income level. In effect, countries with a macroeconomic and institutional environment and technological capabilities that are comparatively high given their level of development are able to grow more rapidly. Many Latin American countries do not fall into this category.

There are only two possible sources of economic growth: the pace at which machinery, education and other factors of production are accumulated, and the productivity with which these factors are used. In both respects, Latin American economies have serious deficiencies. The region has the lowest levels of physical investment of all major areas of the world. Although Latin America has ceased to be a region of unskilled labor, educational levels are growing at a much slower pace than in more educated regions, such as Southeast Asia, or others with lower levels of education, such as the Middle East or the rest of the countries of Asia. On the basis of the accumulation of factors of production alone, Latin America could sustain a growth rate of only 4 percent annually. But more serious is the fact that growth in the last decade was even lower, as declines in productivity subtracted 0.6 points from this modest rate. In contrast, in the developed countries, productivity gains contributed 0.6 points to growth. As a consequence, the growing income gaps between Latin America and the developed countries are the result of growing gaps in productivity. The same can be said within Latin America itself. The only countries where total factor productivity increased substantially in the 1990s were Chile, Argentina and Uruguay, which are among the most developed. Some of the poorest countries in the region—such as Haiti, Honduras and Nicaragua—experienced severe losses in productivity, which cost them more than one percentage point of annual growth over the decade. In an era of such important technological improvements, declines in the productivity of poor countries seem paradoxical. It is just this paradox that underlies the principal themes of this study.

The Entrepreneurial Angle

Information on the quality of the Latin American business environment—such as the World Business Envi-

ronment Surveys produced jointly by the World Bank and the Inter-American Development Bank—presents an outlook for the region that is just as disturbing as that which results from comparisons of productivity. The obstacles to business development most frequently cited in Latin America have to do with the economic and institutional environment, problems that Latin American business communities consider more severe than do business people in other regions of the world.

In the business world, comparisons of the size of large firms in the various sectors in different countries are given considerable attention because they reflect in a simple form the growth capacity of some firms in relation to others. Not surprisingly, the larger the size of an economy, the larger its firms. The large firms of Latin America are much smaller than would be expected for the size of their economies. Large firms in Brazil and Mexico, for example, are smaller than those of Taiwan, a country whose business strategy is directed very much toward small businesses. The small size of Latin American firms is not the result of a similar strategy, but rather the result of insufficient provision of key productive resources such as credit and infrastructure in transportation, energy and telecommunications. These deficiencies represent even greater barriers for the development of small and medium-sized enterprises, which have fewer links with national and internal financial markets and lack the scale to undertake investments to compensate for deficiencies in public infrastructure.

Scope of the Study

The objective of this Report is to identify deficiencies in the markets of the principal productive factors that limit the functioning and productivity of Latin America's private sector, and that can be corrected through public policies. These productive factors are credit (Part II), human resources (Part III), infrastructure for ports, electricity and telecommunications (Part IV), and new information technologies (Part V). The Report discusses the policy options open to governments given the characteristics of the markets and the institutional context in which they operate. Consequently, although the Report presents indicators to compare the supply of productive resources and the policy and regulatory framework in which factor markets operate, it is not presumed that there is a single or ideal recipe to make

each of these markets function properly. Options also extend to industrial and investment policies oriented toward creating comparative advantages, increasing the supply of resources that offer positive externalities (and as such are produced in suboptimal quantities by the market), taking advantage of the government's capacity for coordination to develop complementary investments or create economies of scale, or simply attracting foreign direct investment (Part VI). Of course, developing the productive sectors by making policies more effective also depends critically on macroeconomic stability. But that area is not one of the themes of this Report.

Productive factor markets are rarely perfect markets where there are numerous buyers and sellers with precise information on the good traded and where transactions occur repeatedly and on the spot. This description better fits markets for certain basic consumer or primary goods. The characteristics common to productive factor markets are the limited number of suppliers (and occasionally buyers), incomplete information regarding the good traded or the intentions of the other party, and deferred delivery of goods or services previously agreed upon. These conditions imply problems in terms of lack of competition, rationing or exclusion of some buyers, and the risk that providers might not deliver.

Given the nature of markets for productive factors, their functioning depends critically on institutions; that is to say, the formal and informal rules and enforcement mechanisms that shape the behavior of organizations and individuals in a society (North, 1990). Institutions have a profound influence on the supply, quality and utilization of productive factors. Evidence throughout this Report shows that the quality of institutions is one of the principal reasons why productivity gaps between countries are widening. In Latin America, the quality of regulations and the functional norms of factor markets have improved substantially over the past decade, particularly credit and infrastructure services such as ports, electricity and telecommunications. Regulations have improved as well, although in many countries their implementation and efficacy continue to be affected by other deficiencies in the institutional environment, such as a weak rule of law, corruption, and ineffective government entities.

Another cause of growing productivity gaps is education, since the capacity for technological innovation and assimilation of new technologies is mediated by the knowledge and capacity of workers to learn. In the

absence of adequate systems for training and reassigning workers, modern technologies may have contributed to the obsolescence and underutilization of human capital, and consequently to declines in productivity in countries with low levels of education.

Growing productivity gaps can also be the result of demographic factors as well as patterns of world technological development, which have tended to concentrate research efforts on the products and needs of the most prosperous markets. These areas will not be explored here, however, because they were analyzed in the previous edition of this Report.

Credit Markets

The scarcity of credit is the principal problem faced by firms in Latin America. This is not surprising, given that the supply of private credit as a proportion of GDP in the region is only a third that of the developed countries or Southeast Asia. Although the inadequate depth of the financial sectors of many Latin American countries is due in part to macroeconomic circumstances, the institutional framework is equally or more important, and it can aggravate instability of a macro origin. The functioning of credit markets requires an institutional framework that makes it possible to alleviate problems typical of financial contracts, such as the asymmetry of information, adverse selection, moral hazard, contract enforcement and temporal inconsistency.

Part II of this Report reviews the state of the institutions that are confronting these problems. Although uneven among countries, the greatest reforms in the last decade were in prudential regulation and the opening of financial sectors to foreign investment. The most severe institutional deficiencies that persist are the lack of protection for financial creditors and the various forms of interference by governments in financial contracts. The lack of protection for creditors involves limitations on the use of collateral and the lack of guarantees for the recovery of claims in the event a firm goes bankrupt. Interference in the credit operations of the financial system includes fixing limits on interest rates, restricting methods of payment, and requiring investment in or lending to certain activities and sectors. When these difficulties are combined with uncertain legal frameworks, as is the case in many Latin American countries, the result is a limited sup-

ply of credit, and credit that is highly susceptible to macroeconomic cycles.

Despite widespread privatization during the 1990s, there is still considerable public sector participation in the financial sectors of several Latin American countries relative to other countries of the world. This is cause for concern, as public banking rarely succeeds in widening access to credit or improving the stability and efficiency of the financial sector, since countries do not meet the institutional conditions that would be required for this purpose. Progress has also been limited in developing universal banking, that is, eliminating the segmentation of financial markets according to products or sectors, which in the past was the norm in Latin America.

To compensate for these deficiencies, which particularly affect smaller firms, other institutions have successfully developed in the region. Two outstanding examples are credit information centers and microcredit systems. They have made it possible to alleviate asymmetrical information and credit monitoring problems, consequently reducing credit rationing. Consolidating these successes still requires improving the regulatory and supervisory environment and reducing the uncertainty of the legal frameworks in which these institutions operate.

Labor Markets

Contrary to popular belief, Latin America does not have a relative abundance of unskilled labor. If it did, the region would be best advised to concentrate on the production of unspecialized labor-intensive goods, where international competitiveness depends above all on the cost of labor. However, while Latin America has not attained an educational structure comparable to that of the leading Southeast Asian or developed countries—where production is oriented toward knowledge-intensive goods and goods intensive in technological development—the bulk of the region's labor force has some primary education (complete or incomplete), and some countries have a relatively respectable number of workers with a university education. While this may diminish the region's ability to compete with regions that have a less educated labor force available to produce unskilled labor-intensive goods, it offers the opportunity to more rapidly improve productivity and to penetrate market segments for goods with a medium or high level of technological content. Mexico, Brazil and Costa Rica have already done so.

No productive sector can expect its competitiveness to be based on diminishing the well being of its workers. Even in the most labor-intensive sectors, the possibility of competing and expanding depends not on workers' salaries but on unit labor costs; that is to say, on the combination of the effective cost per worker and the productivity of labor. In many countries of Latin America, the effective cost per worker could be reduced without sacrificing the well being of workers because legislation provides for excessive mandatory benefits that are costly for firms but of little utility to the workers they supposedly aim to help. Legislation also imposes high firing costs that reduce employment, especially for the youngest workers, and minimum wages that in some countries are excessive for the productivity of the least-skilled workers, thus limiting their possibilities for employment.

Working against labor productivity are low educational levels in many Latin American countries, deficiencies in training systems, and the quality of labor relations. The number one priority should be to universalize secondary education through a mix of supply and demand incentives. Better education is essential for improving the future possibilities of labor training systems, yet a profound institutional redesign is necessary in many countries if they are to meet the needs of businesses, improve prospects for employment, and raise the productivity of workers. The elements of success of some new training systems in the region have been greater private sector participation, separation of regulatory functions, and development of mechanisms to compete for public funds. Finally, public policy can improve labor relations by encouraging dialogue between employers and workers and by establishing compensation mechanisms for workers who stand to lose their jobs or their job standing as a result of the introduction of more productive technologies.

Infrastructure

Investments in infrastructure are sensitive to the institutional environment and depend on such elements as well-defined property rights, a predictable regulatory environment, and sufficient transparency in public decision-making to enable investors to commit assets that are immovable and whose profitability depends on a future flow of revenues. Latin America has been a leader in in-

volving the private sector in infrastructure sectors. Investments with private participation in Latin America represent over 43 percent of the total invested in all developing regions. But privatization has not always brought improvements in service coverage, quality and cost.

Despite notable progress over the past decade, Latin American **ports** are still among the most inefficient in the world. For an exporter, the costs of the inefficiencies of a typical port in the region are comparable to being 9,000 kilometers farther away from its customers. It is a matter not only of the slowness of loading and unloading operations, but also of various inefficiencies that depend more on the institutional framework than on physical investments in ports.

Among the several different models of port management, those that are successful share common ingredients that include private participation in port operations, flexible labor restrictions, and control of monopoly power, either through regulation or competition between operators or ports.

Latin America has been a leader in the restructuring of **electricity sectors**, but these reforms have not been consolidated throughout the region. In many countries, competition remains limited and prices high, except for large industrial consumers. In others, rationing has cast doubt on the sufficiency of the incentives being used. In almost all countries, the regulatory system has been criticized for lack of transparency or certainty. These problems, of course, are not unique to Latin America. They are due in part to the technical characteristics of electricity markets, which demand a complex regulatory and operative structure. But in Latin America, these difficulties are exacerbated because many countries lack the legal and institutional framework within which regulatory systems must function.

There is no single ideal organizational and regulatory system for an electricity sector, but the factors that can improve results include separating the principal market segments and opening them to potential competitors, public sector leadership in expanding the power grid (access to which should not be restricted), and the gradual design of the framework of regulatory and operating entities, taking into account the sector's institutional capabilities and limitations.

Two of every three Latin American countries have totally or partially privatized their principal **telecommunications** operator, and half the countries of the region have introduced major regulatory reforms to bring

competition to the sector. Even though telephone penetration in developed countries is still five times greater than in developing countries, this gap has been reduced more rapidly in Latin America than in the rest of the developing world. In recent years, international telephone traffic in Latin America has increased at an annual rate of 15 percent. Reforms in the sector have stimulated penetration and improved the quality of service. Nonetheless, limited competition has prevented efficiency gains from being transferred to consumers, who in many countries are paying higher prices than before the reforms.

In spite of recent progress, Latin America has a long way to go in improving its telecommunications sectors. Gaps in basic telephony must be reduced with respect to other countries and among different social strata within countries. More advanced and critical services such as data transfer and Internet access must be made more widely available to businesses. These challenges require a regulatory framework that facilitates competition within each product and among products. Regulations should facilitate access to networks and promote inter-operability among them. In many countries, this implies integrating regulatory systems into telecommunications sectors that currently treat similar products in a different manner, which constrains the adoption of new technologies.

Technological Innovation

The global revolution in information technology is putting every country's capacity for technological innovation to the test. The new technologies bring the promise of greater productivity by reducing information and transaction costs in all types of sectors. But in Latin America, only one of every 20 persons has Internet access, while in the United States that ratio is one of three. And Latin America has only three Internet hosts for every 10,000 inhabitants, compared to 173 in developed countries. Of course, Internet access may be limited by telephone service coverage. But this is only one of many constraints to reaping the benefits of new technology. Limited levels of education, poor access to credit, and a weak rule of law can also constrain the capacity to assimilate technology.

The fact that information technology is still in its diffusion stage provides an opportunity to determine

the relevance of these variables and to understand in a more general way the causes of Latin America's technological backwardness. Subsidizing computers or the creation of Internet hosts is not going to resolve that problem. In fact, the information technology revolution poses a number of specific policy questions, including government's leadership role, adoption of new technology for government activities, the viability of the government promoting relatively unsophisticated versions of new technologies for poor or marginalized users, and the need to address tax erosion problems implied by widespread use of electronic commerce.

Technological innovation occurs in specific institutions that are not adequately reflected by variables such as those considered above, and in which there is also a scope for the government. The evaluation in this Report of innovation systems in the region shows that Latin America's research and development spending is very limited, that personnel dedicated to these activities are scarce and under-utilized, that the links between businesses and research centers are incipient at best, and that information flows are weak. Each of these areas is open to interventions for improving the technological innovation environment.

Industrial and Investment Policies

Ensuring that productive factor markets function smoothly is a demanding task for governments, since each of those markets requires institutional support. But the government's scope can be extended to supporting in a more direct way the development of certain sectors or investments. The import-substitution strategy was an extreme version of this orientation. Latin American countries are currently experimenting with more moderate approaches to industrial policy that take into account the capabilities of government, avoid creating rents in favored sectors, and aim to firmly integrate the productive sectors into the currents of international commerce and technology. The most important component of these policies is the promotion of exports by means of specialized financial instruments, exemption mechanisms, drawbacks of taxes, and export processing zones. Although a few export subsidies remain, the tendency in the region is toward their elimination. Judging by export performance in the 1990s, export promotion policies have been much more effec-

tive than the more selective policies of the past. Sixteen of the 26 Latin American countries increased the share of world markets in their baskets of export products, and in the region as a whole the share of exports of products with medium or high technological content reached 40 percent of total export value, due in large part to performances by Mexico and Brazil. Investment promotion policies also encompass a variety of financial and fiscal instruments authorized by means of public corporations or development banks. Surprisingly, the sectors most favored by fiscal incentives are not high technology sectors but rather tourism and various primary sectors. The outlook for these policies is mixed, and little is known about their efficacy or, hence, their policy implications.

Changes in the region's treatment of foreign investment have been much more profound. Since the dismantling of restrictions on income and repatriation of foreign investment capital at the start of the 1990s, Latin America has been a major recipient of foreign direct investment (FDI). These resources have served as a channel for technology transfer and as a mechanism for increasing and diversifying exports. Much of what is attractive to foreign investment is not the direct object of public policy—the size of the economy, and distance from and cultural links with the countries that are the source of investment. The tax treatment of investment is a policy variable that is effective in attracting foreign investment, but its widespread use could prove destructive for the region. This leaves the quality of public institutions as the sole but powerful policy instrument to attract investment. This particularly involves the regulatory framework, the rule of law, and control of corruption, variables that occupy a prominent place throughout this Report.

The governments and private sectors of the Latin American countries are quite justified in their focus on the quality of the economic and institutional environment in which firms operate. The obstacles most difficult to overcome to unleash the region's economic growth potential are not the lack of capital or technological knowledge. Rather, they are obstacles that are deeper and more difficult to change, such as the norms, regulations and practices that make up the institutional system of each society. The goal of this Report is to help governments and private sectors identify and overcome these institutional obstacles that constrain the efficient use of productive resources and the generation of new productive capabilities.