



Recovering Growth

Rebuilding Dynamic Post-COVID-19 Economies
Amid Fiscal Constraints



Latin America is emerging from the COVID-19 crisis, but the recovery is weaker than expected, and the scars on the economy and society will take years to fade. The need to recover dynamic, inclusive, and sustainable growth to redress both the legacy of the pandemic and long-standing social needs has never been more acute. In turn, despite the emergence of some industrial “green shoots” offering new avenues for growth, addressing long-unattended agendas that prevent the region from taking off has never been more urgent. In this spirit, Chapter 1 of this report lays out the recent social and macroeconomic evolution of the region and the near-term challenges it faces emerging from the pandemic. Chapter 2 then explores several of the areas where key growth-advancing reforms could be undertaken in the constrained fiscal context, focusing especially on spending more efficiently and reallocating resources to more productive uses.

The social costs of the pandemic have been devastating. Poverty rates, excluding Brazil, measured at 5.5 USD/day rose from 24 to 26.7 percent, their highest increase in decades; students lost between one and one-and-a-half years of education; and the fall in the UN Human Development Index dwarfed that during the financial crisis. The good news is that the vaccination drive has picked up steam over the last six months and, while still far from where it needs to be, COVID-19 deaths are falling in most countries.

Latin America and the Caribbean's (LAC's) economic recovery is stronger than predicted earlier in the year, but weaker than favorable tailwinds would dictate. Forecasts of 2021 growth have been upgraded over the summer and regional growth is expected to reach 6.3 percent for 2021, almost recovering the 6.7 percent losses of 2020. However, given the robust recoveries in their principal trading partners, low global borrowing rates, and the prospect of another commodity super cycle, growth rates might be expected to be 1.5 percentage points higher.

...And several challenges face the recovery:

Recurrence of the virus. Any recurrence of the virus will lead to declines in economic activity, not only because of government measures to enforce social distancing, but also because half of the decline in activity is due to voluntary distancing due to fear of the disease.

Tightening of global liquidity to tamp down inflation. Should global inflation pressures not prove temporary, global borrowing rates will rise, depressing demand and challenging budget management.

High levels of private sector debt and lack of clarity on banking solidity. World Bank Pulse Surveys suggest that in many countries 40-60 percent of firms are in arrears as a result of pandemic-driven falls in revenues. This overhang will in the best case dampen investment, and in the worst case create zombie firms that are effectively bankrupt but are still in operation. To the degree that banking systems are forbearing debt payments, this could also be creating a de-transparentization of the financial sector, where the true level of non-performing loans in the system is hard to discern. Governments will need to streamline presently unwieldy debt resolution mechanisms and monitor systemic soundness.

Rising budget deficits. Declining government revenues and extraordinary efforts to protect families and firms during the COVID-19 pandemic have led to high deficits, and increased debt. In some cases, this has led to ratings downgrades and potentially raised borrowing costs. In all cases, there is reduced room for governments to engage in growth and equity promoting investments.

Rising public debt: The average public debt to Gross Domestic Product (GDP) ratio has risen dramatically over two years by 15 points to 75.38 percent, leading to reduced ability to borrow abroad and complicating fiscal management going forward.

The COVID-19 crisis came on top of another “lost decade” of low growth, suggesting deeper structural problems. From 2010 to the outbreak of the pandemic, LAC grew at 2.2 percent per year while the world grew at 3.1 percent. The forecasts for 2022 and 2023 are similarly lackluster at 2.8 and 2.6 percent, respectively. The lackluster recovery, together with the low growth rates of the previous decade suggest structural problems internal to the region and point to the urgency of addressing the list of long-recognized growth-impeding internal shortfalls in infrastructure, education, energy policy, firm capabilities, and innovation, while confronting some new climate change challenges.

The situation is not uniformly bleak across countries and industries and historically, green shoots may arise from crises triggering large-scale economic restructuring. As an example, while hospitality and personal services have suffered greatly, accelerated digitization brought about by the need to socially distance could help boost sectors like information technology, finance, and logistics and these may, in turn, enhance market competition and increase economic efficiency. However, unless these structural factors are addressed, anemic growth is likely to continue and will be insufficient to make progress on poverty and relieve social tensions.

Taking Off: Rebuilding Dynamic, Inclusive, and Greener Economies with Limited Fiscal Resources.

Chapter 2 focuses on possible ways of raising potential growth and societal well-being with limited fiscal space through three channels: raising additional revenues, increasing the efficiency of current spending, and reallocating spending to higher growth/higher social value added areas. Progress in each area requires increasing the transparency of public spending and information about it, increasing public sector accountability and employing private sector discipline, working toward consistency and coherence across programs, and maintaining an equity lens throughout.

Growth Neutral Revenue Mobilization

Emerging evidence suggests that there is room for increased revenue mobilization without large negative impacts on growth. The popular value added tax (VAT), for example, appears to have negative growth impacts for countries with already high tax burdens, but for countries with rates between 7.5 percent and 14 percent, the negative effects are small, and expansion is feasible. However, because it weighs on consumption, the VAT is regressive and potentially exacerbates inequality. By contrast, income taxes can be designed to be more progressive, but are estimated to have a larger negative impact on output in LAC than, for example, in the United States. Property taxes as a share of GDP in LAC are generally below 0.6 percent of GDP, while the Organisation for Economic Co-operation and Development (OECD) level is 2 percent and offers another potential source of revenue, that, again, would be more progressive. Taxes on tobacco, alcohol and sugar sweetened products generate health benefits and revenues. Increasing the excise taxes has been estimated to raise the tax to GDP ratios by an average of 0.7 percent in low-income countries (LICs) and low-to-middle-income countries (LMICs) and, when health impacts are taken into account, the impact of the increase is progressive. The goal of lowering carbon emissions may also involve levying taxes which would also raise revenues although the magnitudes and equity impacts are as yet unclear for the region. Finally, there are gains to be made in tax enforcement. For example, the regional average evasion rates for VAT and corporate income taxes are 29.4 and 49.2 respectively.

Gains in Spending Efficiency

Large potential gains in spending efficiency offer an important complement or alternative to raising revenues. This does not mean cutting spending across the board, as has been done many times in the past, with strong contractionary effects. It means using existing resources better. Estimated inefficiencies in procurement, civil service, and targeted transfers in LAC represent an *average amount of waste in the region of 4.4 percent of GDP*-larger than the current average spending on health and almost as large as the average spending on education- and accounts for about 16 percent of average government spending. Public procurement of goods, services, and capital equipment accounts for, on average 30 percent of spending and is frequently a source of waste, mismanagement, and in some cases corruption. The waste originating in bribes and

padding budgets appears to be enormous: about 26 percent over the cost of projects. World Bank simulations estimate savings of 16 to 22 percent with straightforward modifications in practices and without changing existing procurement laws. The average wage bill consumes 29 percent of general government spending, and wage bill inefficiencies are estimated to cost 1.2 percent of GDP. About 30 percent of public spending on average in LAC consists of transfers, including social programs, firm subsidies (mostly energy), and contributory pensions; inefficiencies through mistargeting and waste are estimated at about 1.7 percent of GDP.

Rethinking Spending Priorities for Growth and Equity

Strengthening the Health System Quick Wins to Improve and Expand Service. COVID-19 revealed the limitations of the health systems in most LAC countries. Over time, public spending will need to increase to international levels, but in the short term, moving systems toward the global efficiency frontier has the potential to extend average lifespan by four years. This includes benchmarking services offered against global norms, undertaking Health Technology Assessments, unifying fragmented systems, reconfiguring services provision, improving information systems, and reducing corruption.

Making Better Grades in Education Efficacy and Equity. Over the medium term, substantial remedial work will need to be done at the elementary school level, to counteract the lost years of learning and human capital accumulation due to COVID-19, while addressing long-standing inefficiencies that have led to perennially inadequate outcomes. Prioritizing the hardest hit schools, better use of technology to complement teaching, improving monitoring and reporting of educational outcomes, and improving educational leadership would all contribute. At the university level, shifting the ample funding from bachelor programs to Short Course Programs (two to three years) more focused on particular technical skills in line with global norms would be progressive, address a persistent skill shortage in the private sector, and improve labor market outcomes. More generally, collecting and diffusing information on and increasing accountability for school outcomes and revisiting the allocation of subsidies across programs would all make the higher education system more effective and less regressive.

Getting More from Innovation Spending. LAC underinvests in research and innovation—as a crude proxy, average research and development (R&D) expenditures are 0.6 percent of GDP compared to double that (1.2 percent) for middle-income countries and 1.4 percent for upper-middle-income countries. Further, the private sector reports both low confidence in the quality of research institutes and little interaction with them by global standards. Revisiting funding mechanisms to strengthen incentives to quality and collaboration would ensure that scarce innovation resources have an impact on growth. Reprioritizing away from R&D toward strengthening managerial capabilities and product and process innovation would, over the long run, facilitate participation in global value chains (GVCs), and prepare firms for longer-term innovation projects, including the transition to greener technologies.

Public Transfers for Equity: Converting Short-Term Stimulus to Long-Term Growth. Public transfers were important to supporting households during COVID-19 and, over the longer term, higher flows are likely necessary to approach OECD levels of equality. The evidence to date suggests a positive short-term impact on output through demand, but over the longer term, targeting transfers to support productivity increasing investments (for instance subsidies to Short Cycle programs, or other human capital accumulation) would both improve equity and lay the foundation for growth.

Smart Public Investment in Infrastructure. Public investment in infrastructure as a share of GDP has fallen by two-thirds since the 1980s and has not been offset by public-private partnerships (PPPs) or other private funding mechanisms. The overall fall has negative adverse impacts on competitiveness, growth, and inequality. Studies identify barriers to better using existing resources including weak planning, project appraisal, and preparation capacity; overly rigid or myopic budgeting designed to control fiscal deficits rather than promote efficient spending; difficulties with budget execution; unclear project sustainability, often due to imbalances between capital and current spending on infrastructure, often arising, again, from overly rigid budgets and suboptimal planning; weak procurement practices; and finally, often uncompetitive construction industries. Savings in traditional infrastructure are potentially large. Expansion of digital infrastructure is relatively cheap and could increase productivity, connect rural areas, and build in resilience to future crises, for instance, through broader access to distance learning.

Powering a Sustainable Energy Future. Depending on global energy prices, energy subsidies can cost several points of GDP and remain poorly targeted: 40-60 percent of electricity subsidies, for example, go to the top 20 percent of the income distribution. Shifting away from general subsidies and providing targeted support to vulnerable populations would free up resources to explore conservation measures and other sources of low cost and environmentally sustainable power. The region's gains in energy efficiency have been below those of comparable regions, and the World Bank has identified hundreds of potential energy savings areas ranging from building codes, setting minimum energy performance standards, and developing financial mechanisms to support investments that would contribute. LAC also has a comparative advantage in generating Green Hydrogen which, if scaled, would be competitive in world markets and reduce emissions across many domestic industries.

Growth Outlook for the Region

REAL GDP GROWTH RATES					
	2019	2020E	2021F	2022F	2023F
Argentina	-2.0	-9.9	7.5	2.6	2.1
Bahamas	0.7	-14.5	2.0	8.0	4.0
Barbados	-1.3	-18.0	3.3	8.5	4.8
Belize	1.8	-14.0	9.0	4.0	1.8
Bolivia	2.2	-8.8	5.5	3.5	2.7
Brazil	1.4	-4.1	5.3	1.7	2.5
Chile	0.9	-5.8	10.6	2.4	1.8
Colombia	3.3	-6.8	7.7	4.2	3.9
Costa Rica	2.3	-4.1	3.8	3.5	3.2
Dominica	3.5	-11.0	3.4	8.1	5.9
Dominican Republic	5.1	-6.7	9.1	4.9	4.9
Ecuador	0.0	-7.8	3.0	3.4	2.2
El Salvador	2.6	-7.9	8.0	4.0	2.5
Grenada	0.7	-13.7	3.0	4.4	3.8
Guatemala	3.9	-1.5	5.1	4.1	3.5
Guyana	5.4	43.5	21.2	49.7	25.0
Haiti	-1.7	-3.3	-0.8	3.2	1.4
Honduras	2.7	-9.0	4.7	4.4	3.8
Jamaica	0.9	-10.0	3.5	4.0	2.8
Mexico	-0.2	-8.3	5.7	3.0	2.2
Nicaragua	-3.7	-2.0	5.5	3.0	2.5
Panama	3.0	-17.9	9.9	7.5	5.0
Paraguay	-0.4	-0.6	4.3	4.0	3.9
Peru	2.2	-11.1	11.3	3.2	3.0
St. Lucia	-0.1	-20.4	3.3	10.6	7.8
St. Vincent and the Grenadines	0.5	-3.0	-6.1	8.3	6.1
Suriname	1.1	-15.9	-3.5	1.8	2.1
Uruguay	0.4	-5.9	3.4	3.1	2.5
Latin America and the Caribbean	0.8	-6.7	6.3	2.8	2.6

Source: World Bank and staff calculations.
Note: The cut-off date for the data is September 23, 2021.