CENTRAL AMERICA: Institutions challenge reform schemes

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Abstract

The outlook for successful reform programmes.

Economic transformation in Central America over the past 30 years has been heavily influenced by policy advice and conditions overseen by international financial institutions (IFIs). Strengthening governance and institutional reform have lagged, while social and poverty indicators are still among the worst in the Americas.

Full Text

SUBJECT:The outlook for successful reform programmes.

SIGNIFICANCE:Economic transformation in Central America over the past 30 years has been heavily influenced by policy advice and conditions overseen by international financial institutions (IFIs). Strengthening governance and institutional reform have lagged, while social and poverty indicators are still among the worst in the Americas.

ANALYSIS: Impacts.

Performance in implementing economic, social and institutional reforms will remain mixed across the region.

Weak institutions will pose the greatest challenge in all cases, except Costa Rica.

Responding to insecurity and violence will rely on militarised responses beyond the remit of the IFIs.

The democratisation and peace processes in Central America in the 1990s were accompanied by ambitious economic and social programmes. IFIs have played a central role in promoting successive waves of reform in the region. These were introduced concurrently with four key objectives -- macroeconomic stabilisation, liberalisation, reduction in the role of the state and social policy innovation:

Macroeconomic stabilisation to reduce inflation, manage external debt and cut fiscal deficits has remained central to IMF programmes, and serves as the overarching framework for all development strategies and economic and social policies.

Liberalisation and export development were prioritised for growth. Reforms involved the dismantling of state supports for traditional exports such as coffee, sugar and bananas, diversification to include new sectors, and meeting international trade standards in the context of the Caribbean Basin Initiative and the WTO. In the 2000s reform programmes encompassed intense preparations for joining the CAFTA-DR trade agreements with the United States and for maximising the benefits from this process.

The reduction in the role and size of the state in the economy has been a key process for managing fiscal deficits and creating effective, efficient institutions. Streamlining the state, cutting and restructuring public sector employment, and the privatisation of state-owned enterprises and public utilities remain central to IMF agreements and World Bank lending in the region.

Social policy innovations included the introduction of social funds and conditional cash transfers as part of a decentralised approach to delivering basic social services. Poverty reduction strategies papers (PRSPs) were introduced in Honduras and Nicaragua, with some emulation in El Salvador and Guatemala.

Mixed economic transformation.

The timing of reforms and the outcomes in terms of economic performance have been mixed:

Costa Rica adopted structural adjustment early in the 1980s. By 1995 the focus of lending had broadened to enhancing competitiveness, improving public finances and sector lending. Policies were successful in delivering export diversification and technological upgrading, and Costa Rica became a regional leader in trade diversification.

El Salvador and Guatemala began reforms after peace processes in the early 1990s, leading to successful re-integration into the world economy. Significant trade diversification and export expansion took place, although many of the gains were in low-skilled sectors. Poverty and social indicators continued to lag and institutional weaknesses and governance challenges increased in the 2000s.

In Honduras and Nicaragua, reform processes targeted public sector modernisation. Export diversification and growth were modest, while high external debt levels persist. Hurricane Mitch damaged vast portions of productive infrastructure in 1998. An unprecedented international disaster response led to national poverty reduction strategies, overseen by the World Bank and the IMF.

Challenges persist.

Macroeconomic stability and growth in the early 2000s were not matched by success in transforming the state or radical improvements in poverty and social indicators:

Political resistance to reforming state institutions has proved tenacious.

Fiscal discipline has tended to lapse in line with electoral cycles. Corruption and clientelism in state institutions has persisted.

Political commitment to tax reform has been weak, leaving national tax revenues low. Demands for national tax increases to finance new security policies met with intense resistance from business sectors (see CENTRAL AMERICA: Security integration needs tax funds - July 6, 2011).

Repeated efforts to tackle high poverty rates and improve the provision of social services have suffered from these obstacles. Limited national resources have meant that social programmes, including core spending, social funds and conditional cash transfer programmes (CCTs) rely heavily on aid flows.

By 2009, the effects of the global crisis, and deteriorating governance, revealed persistent institutional weaknesses as well as new challenges for reform processes:

El Salvador. Institutional reform has been undermined by corruption and clientelism. A recent stand-off between parliament and executive exposed deep polarisation and politicisation in state institutions. Challenges to the rule of law from organised crime and violence have grown, undermining trade and investment.

Guatemala. Political commitment to tax reform has been extremely weak. Attempts to allocate resources to social and poverty issues have been displaced by security spending. Escalating violence and governance deficits threaten to undermine the potential of the export sector.

Honduras. Successive attempts to overhaul the civil service and manage the public sector wage bill failed in the 1990s and 2000s due to politicisation. The PRSP process was abandoned from 2007 due to corruption and IMF agreements and World Bank lending were suspended as a result of the coup in 2009. Political polarisation and deteriorating governance have undermined renewed efforts to resuscitate reform processes.

Nicaragua. Deep institutional reform has been undermined by politicisation. The PRSP process was abandoned after President Daniel Ortega took office in 2007, replaced by an alternative national strategy. The IMF continues to maintain good relations with Ortega's government as a result of orthodox macroeconomic policy. Aid from Venezuela has eclipsed the role of the World Bank in economic and social policy, while other donors have withdrawn as a result of the politicisation of institutions.

Costa Rica. In contrast, robust democratic institutions and good governance provided strong initial conditions for reform processes, especially for the modernisation of the state. After 30 years of reforms, public opinion remains divided by processes to reduce public sector employment, privatise public utilities and cut social spending. Economic outcomes have been positive and there has been continuity in political commitment to reforms by successive governments since 1982.

Outlook.

The global financial crisis has called orthodox policies into question. Aid flows to the Central American region from official donors have also declined, while processes for aid harmonisation have diminished in importance. Alternative aid flows from Venezuela have also displaced World Bank influence, while new trade opportunities with countries such as China diversified the options available. Insecurity and violence have highlighted reform processes difficulties to deal with weak institutions, with regional initiatives to address security led by the US government (see CENTRAL AMERICA: Regional drug responses fall short - April 26, 2012). Without strong financial commitment from USAID and political pressure for countries to comply with reforms to co-finance the strategy, the IFIs' influence over policy will be limited.

CONCLUSION: The IMF will maintain a key role in macroeconomic policy in the region, including offsetting the effects of the global financial crisis. The role of the World Bank in the overall tone of broader economic and social policy and associated reform processes will be overshadowed in a context marked by a militarised response to insecurity and violence and the direct intervention of the United States.

Details

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