Economic Freedom and Transparency in Latin America

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The Center for the Opening and Development of Latin America (CADAL), based in Buenos Aires, was incorporated as a Foundation on February 26 2003 with the object of strengthening democracies, rule of law and the economic freedom in the countries of the region. To that end, CADAL carries out activities analyzing, investigating, promoting and training in the following areas: Latin American Politics, Human Rights, Journalism and Democracy, Economy and Rule of Law, Modernizing the Political Parties, and Development and Institutional Communications. CADAL is a member of the Network of Democracy Research Institutes and has received two international awards for its work: “2005 Templeton Freedom Award Grant for Institute Excellence” and “2005 Francisco De Vitoria Prize for Ethics and Values”.

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This Report elaborates a ranking of economic freedom and transparency in Latin America by weighing four indexes. In Part I, the ranking measures the performance of countries and in Part II, it measures the performance of the region’s different blocs and political associations. The four indexes that are used are: Heritage Foundation’s Index of Economic Freedom, Transparency International’s Corruption Perceptions Index, and the World Bank’s Rule of Law Index and Government Efficiency Index.

Heritage Foundation’s Index defines economic freedom as “absence of government coercion or constraint on the production, distribution, or consumption of goods and services”. The index is based on ten factors that are averaged: 1) trade policy, 2) fiscal burden of government, 3) government intervention in the economy, 4) monetary policy, 5) foreign investment, 6) banking and finance, 7) wages and prices, 8) property rights, 9) regulation, and 10) informal market activity1. On the other hand, Transparency International states that “the Corruption Perceptions Index (CPI) establishes each year a ranking of countries based on their levels of corruption in the public sector perceived by businessmen, risk analysts and ordinary citizens2.”

Thirdly, the Rule of Law Index includes different indicators that measure the extent to which agents have confidence in and abide by the rules of society. These include perceptions of the incidence of crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts.

Finally, the Government Efficiency Index combines surveys on the quality of public service delivery, the quality of bureaucracy, the competence of bureaucrats, bureaucracy’s independence from political pressure and the credibility of the government’s commitment towards the policies it aims to implement3.

All of these indexes are weighted equally (25%).

Part I

As stated by Ades and Di Tella, “It is difficult to overstate the economic and social significance of corruption. Yet, the lack of reliable and systematic data has kept corruption out of the research agenda of empirical economists. This allowed speculation to include such basic issues as whether corruption is good or bad for growth or whether corruption is determined by economic or cultural forces.”4 However, with the availability of so much information, it is necessary to note that analysts who have not studied the economic effects of corruption belong to other fields of social science.

In this part of the Report, we will elaborate a ranking of countries based on economic freedom and transparency. As mentioned above, given that economic freedom primarily depends on an institutional framework where clear and equal rules exist and are observed, we must incorporate an index that measures Rule of Law and another that examines the efficiency of a government to implement hypothetically good norms that are in force.

The outstanding element in Table 1 is the great difference between Chile and the rest. As stated by the World Economic Forum’s last competitiveness report, “…In Latin America, we note that Chile improved its performance significantly, moving up from 28th to 22nd place in the overall rankings. Chile not only has the highest ranking in Latin America, but the gap with respect to its nearest rival (Mexico) is a full 26 places; there is no other continent in the world where we can observe this symbolic “migration” from the region, in terms of performance.”5

| Table 1 Ranking of Economic Freedom and Transparency in Latin America |
|-----------------|-----|
| 1 Chile         | 8.16|
| 2 Uruguay       | 6.32|
| 3 Costa Rica    | 5.97|
| 4 Trinidad y Tobago | 5.69 |
| 5 Belice        | 5.4 |
| 6 Panama        | 5.09|
| 7 El Salvador   | 5.05|
| 8 Jamaica       | 4.8 |
| 9 Mexico        | 4.7 |
| 10 Brazil       | 4.7 |
| 11 Colombia     | 4.08|
| 12 Peru         | 3.87|
| 13 Bolivía      | 3.66|
| 14 Dominican Rep. | 3.51 |
| 15 Nicaragua    | 3.43|
| 16 Argentina    | 3.34|
| 17 Honduras     | 3.1 |
| 18 Ecuador      | 2.76|
| 19 Guatemala    | 2.63|
| 20 Cuba         | 2.56|
| 21 Paraguay     | 2.08|
| 22 Venezuela    | 1.86|
| 23 Haiti        | 0.82|

1 http://www.heritage.org/research/features/index/  
It is important to compare the main Latin American countries’ performance with those of the hemisphere’s two most advanced nations: Canada and the United States. This illustrates Chile’s symbolic migration that has been pointed out in the World Economic Forum’s Report. Institutionally speaking, we can maintain that there are two Americas: one that includes the United States, Canada and Chile, and another made up of the rest of the countries. Venezuela’s performance is particularly poor as measured by each of the four indexes. As stated by Ades and Di Tella, “Examples of a positive connection between rents and corruption abound. Consider the case of Nigeria in the 1970s. When compared to other, non-oil-producing countries in the region, like Togo, Nigeria provides what is almost a natural experiment for the hypothesis that rents cause corruption. After the oil shock, observers noted that Nigeria’s oil income created extraordinary opportunities for corruption. An article in The Economist (August 4, 1984) went so far as to observe: Oil and corruption go together. Nigeria’s oil accounts for about 80% of government revenue. The official price of crude increased 17-fold in eight years from about $2 a barrel in 1973-4 to $34 by the end of 1981. Nigeria went on a construction and importing spree: Parties and party officials grew rich…”

The current case of Venezuela is illustrative (and similar to its situation during the oil shock in the 70s): while its corruption perceptions indicators remain high but stable, we see that its extraordinary income from high oil prices is currently used to block FTAA negotiations and finance radical movements in other countries, among other things. Therefore, we can identify a direct relation between a dominant natural resource, more corruption and less economic freedom.

**Part II**

In this second part of the Report, we will analyze the degree of transparency and economic freedom in Latin American trade blocs and political agreements. We will do this by weighting the indexes by the relative weight of each member’s Gross Domestic Product (GDP). The blocs and political agreements that are studied are: FTAA (in process of being created), CAFTA, NAFTA, MERCOSUR, Andean Community, South American Community of Nations, Central American Integration System (SICA in Spanish) and the Bolivarian Alternative for Latin America and the Caribbean (ALBA; set forth by president Chávez). Then, we will present a Regional Ranking of Economic Freedom and Transparency.

So far, the only aspects of free trade agreements and political associations that have been taken into account are their economic and strategic dimensions. We must incorporate their institutional implications. We have already pointed out that the latter are intimately related to the institutional quality and relevance of countries that a particular State is seeking to sign an agreement with. For example, for Mexico, not only did NAFTA represent the possibility of gaining access to a new environment in which its partners (the United States and Canada) extended Mexico’s potential market by twelve-fold but, more important, it has brought an increase in institutional predictability and credibility in a country that is economically unstable and politically arbitrary.

On the other hand, political and commercial integration in the rest of the continent seems to follow a different logic (with the aforementioned exception of Mexico, the possible exception of CAFTA and the ever-more remote FTAA). From MERCOSUR’s inherent logic, to the Andean Community and the South American Community of Nations, to the magical realism of ALBA, the regional integration processes prioritize associations with countries that have an equal or worse tradition of respect for Rule of Law.

In this sense, we will compare Mexico’s integration into NAFTA with Uruguay’s integration into MERCOSUR. We will try to learn a few lessons from Mexico and Uruguay’s priority and choice of integration with more powerful and dominating neighbors: the United States-Canada and Brazil-Argentina, respectively. Even though there is a greater asymmetry between Mexico and the United States-Canada than between Uruguay and Brazil-Argentina, the comparison of the benefits of the integration processes is valid provided integration assumes accepting the other’s leadership and aspects of its institutional and legal tradition that it will undoubtedly incorporate into the agreement.

In this way, trade blocs create an influence among members but major countries (such as the United States, Brazil, Germany, France) will necessarily have a greater effect on the political, economic and ethic philosophy of the final institutional arrangement.

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Provided a free trade agreement supposes an attempt to extend the economic and political environment of the countries involved, we can try to measure the higher or lower degree of transparency of the new bloc (compared to the country) by weighting the four indexes by the relative weight of each member’s GDP in the new agreement.

We can see that the three highest-scoring institutional agreements include the United States and/or Canada. Also, the last five are low quality agreements, with scores that are far from an acceptable institutional performance. Integration with two more transparent countries like the United States and Canada does not make Mexico more transparent per se (the evolution of Transparency International’s Index shows this between 1995 and 2004). However, it does entail a trade negotiation in which the inefficient and non-transparent Mexican bureaucracy had to negotiate in a new institutional environment with counterparts (the United States and Canada) that not only had more efficient and transparent bureaucracies but whose GDPs were so much greater than Mexico’s that it made their greater degree of transparency and efficiency truly affect the norms that resulted from NAFTA.

So, while Mexico’s score jumps from 4.78 when taken as a country to 8.25 when taken as a member of NAFTA, Uruguay’s score drops from 6.32 when taken as a country to 4.36 when taken as a member of MERCOSUR. This is because Uruguay’s association with Brazil and Argentina entails an asymmetrical negotiation with two inefficient and non-transparent bureaucracies.

A Valid Comparison: The European Experience

The opposite case is presented by the enlargement of the European Union. As of May 2004, ten new members (Czech Republic, Cyprus, Estonia, Latvia, Lithuania, Poland, Hungary, Malta, Slovakia, and Slovenia) joined the previous fifteen (the original six countries that signed the Treaty of Rome in 1957: Germany, France, Italy, Holland, Belgium, and Luxemburg, plus Denmark, Ireland and the United Kingdom in 1973, Greece in 1981, Spain and Portugal in 1986 and Austria, Finland and Sweden in 1995). Also, Rumania and Bulgaria are scheduled to join on January 1, 2007. Finally, Turkey is an official candidate to join the EU and will begin negotiations in October 2005, although many analysts believe 2015 will be the year it will actually join given the number of economic and social reforms it must implement to do so7.

In order to join the European Union, a State must fulfill certain economic and political conditions known as the “Copenhagen criteria” (in force after the summit that took place in this Danish city in June 1993). Also, according to the EU Treaty, each Member State and the European Parliament must accept the new country. The “Copenhagen criteria” are the rule that determine if a country is eligible to join the European Union. The criteria require that a State have institutions to preserve a democratic government and human rights, a market economy, and it must accept the EU’s obligations and intentions8.

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7 Information available at Wikipedia: http://en.wikipedia.org/wiki/European_Union#Member_states_and_enlargement
8 We can quote some of the conclusions from Copenhagen: “Membership requires that the candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and, protection of minorities, the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union. Membership presupposes the candidate’s ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union” Quoted in Wikipedia.
Table 5 displays the ranking of the 25 Member States of the European Union. Table 6 compares the performance of the European bloc before and after enlargement. We can see how the new members gain in institutional quality after they join the EU. This is the point of comparison that is relevant to Latin America: economic integration is only a part, even a minor part, of an integration process. In order to consolidate economic freedom, it is necessary to establish institutional arrangements with partners that have higher quality and predictability. In this sense, we can say that Latin America is literally walking away from progress.

When we analyze the new members’ performance before they joined the European Union (when they had agreed to begin negotiations), we note a true improvement in their institutional performance due to the incentives created by the possibility of joining the EU if they fulfilled the stipulated conditions.

So, while Rule of Law has not varied for the Western European founding members of the EU, the ten new Member States have improved the performance of the courts and the independence of powers after their inclusion into the EU. Even though the joining of the Eastern European countries is very recent, the evolution of their institutional performance due to the incentives created by their potential membership may have a revolutionary implication: it may justify the need for an analytical revision of the negative view different observers have of free trade treaties or regional integration processes such as the EU. The point is that, as mentioned above, so far, the analysis only focused on the new bloc’s effects on trade, with its ensuing extra-bloc protectionist policies and trade deviation. What is lacking is an adequate analysis of the possibility of strengthening Rule of Law in new member states (for example, the ten countries in the EU or Mexico in NAFTA).

Given this new perspective, we maintain that an integration process where a dominant player with high institutional quality (for example, the United States-Canada vs. Mexico, 15-member Europe vs. 10 new members) determines the future institutional arrangement, will create the necessary incentives for the ‘smaller’ player to produce a domestic political coalition that will accept and enforce good institutional reforms. On the other hand, when there are dominant players with poor institutional quality (such as Brazil and Argentina), ‘smaller’ players like Uruguay will find themselves in an integration process where the political class will have no incentives to accept good reforms because the civil society will not perceive membership as an opportunity to improve and achieve the dominant players’ higher institutional quality.

Integration processes create opportunities and incentives for countries that are involved. The formation of a new institutional environment seeks to enrich each one of the players with “something” new. However, when poor, corrupt countries (big or small) join other poor, corrupt countries, both government officials and the civil society have no incentives to promote changes that are necessary for progress. But, when a poor and non-transparent country joins an integration process with wealthier and more transparent countries, it creates a series of incentives for its civil society that in turn, forces government officials to promote institutional reforms aimed at completing the integration process.

So, we can state that while the consolidation of MERCOSUR, the Andean Community or eventually ALBA will be a success for the non-transparent local political classes (with the public opinion’s indifference or possibly support), the integration of Mexico into NAFTA, the Central American countries’ integration into CAFTA, or the ten new countries’ integration into the EU, are a victory for their respective civil societies, in many cases, in spite of their respective corrupt and inefficient political classes.
Final Remarks

Why is the index of economic freedom and transparency made up of four indicators? Because the attempt to measure both variables must include, apart from Heritage Foundation and Transparency International’s indexes, additional indicators that reflect the institutional conditions that are needed to consolidate openness and limit corruption. These additional indicators are “Rule of Law” and “Government Efficiency”, produced by the World Bank.

Also, these two indicators are vital in creating a ranking that measures the degree of economic freedom and transparency not only of countries but also of trade blocs and commercial associations. The aim of the present Report is to show how a successful and convenient integration process depends mainly on the institutional quality of the partners a specific country will have in the new institutional agreement.

In order to study the benefits and convenience of integration processes, we compare the opportunity that NAFTA represented for Mexico with the institutional limitation that MERCOSUR represented for Uruguay. This comparison (that may seem arbitrary at first glance) is carried out because it entails an asymmetrical relation between two countries and their respective dominant partners in the blocs in question. The point is that countries that are relatively small, poor and with a certain degree of transparency, should seek to partner with countries that can provide a greater economic dimension and higher institutional quality. In an asymmetrical process of negotiation, countries with a greater relative weight will impose the economic and institutional conditions in the new framework. This is exactly what has happened to Mexico and Uruguay. Their respective membership in NAFTA and MERCOSUR means that they form part of a new environment. This new environment, when compared to the country itself, proved to be of a greater institutional quality in Mexico’s case, and of a poorer quality in Uruguay’s case.

We measure this by weighing the indicators by the each economy’s relative weight in its existing or potential bloc or association. These blocs can be political-economic (MERCOSUR), just economic (NAFTA) or just political (South American Community of Nations).

We have also mentioned a revolutionary implication of the European Union’s enlargement: for the first time in modern history, an integration process has created significant incentives for its members. These incentives have radically modified, in a short period of time, social and institutional conditions in countries that lived in poverty and totalitarianism only fifteen years ago.

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Chile heads the Ranking 2005 of Economic Freedom and Transparency in Latin America with a score of 8.16, followed by Uruguay with 6.32 and Costa Rica with 5.97. Argentina is in 16th place with a score of 3.34 and is ahead of Honduras (3.10), Ecuador (2.76), Guatemala (2.63), Cuba (2.56), Paraguay (2.08), Venezuela (1.86) and Haiti (0.82). Mexico (4.78) and Brazil (4.70) are ranked 9th and 10th, respectively.

From MERCOSUR’s inherent logic, to the Andean Community and the South American Community of Nations, to the magical realism of ALBA, the regional integration processes prioritize associations with countries that have an equal or worse tradition of respect for Rule of Law. So, while Mexico’s score jumps from 4.78 when taken as a country to 8.25 when taken as a member of NAFTA, Uruguay’s score drops from 6.32 when taken as a country to 4.36 when taken as a member of MERCOSUR. This is because Uruguay’s association with Brazil and Argentina entails an asymmetrical negotiation with two inefficient and nontransparent bureaucracies.

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An integration process where a dominant player with high institutional quality (for example, the United States-Canada vs. Mexico, 15-member Europe vs. 10 new members) determines the future institutional arrangement, will create the necessary incentives for the ‘smaller’ player to produce a domestic political coalition that will accept and enforce good institutional reforms. On the other hand, when there are dominant players with poor institutional quality (such as Brazil and Argentina), ‘smaller’ players like Uruguay will find themselves in an integration process where the political class will have no incentives to accept good reforms because the civil society will not perceive membership as an opportunity to improve and achieve the dominant players’ higher institutional quality.