The Latin American Efficiency Gap

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Francesco Caselli[1]

[1]Bureau for Research and Economic Analysis of Development; Centre for Economic Performance; Centre for Economic Policy Research; Centre for Macroeconomics; London School of Economics; and National Bureau of Economic Research.

The average Latin American country produces about 1 fifth of the output per worker of the US. What are the sources of these enormous income gaps? This paper reports development-accounting results for Latin America. Development accounting compares differences in income per worker between developing and developed countries to counter-factual differences attributable to observable components of physical and human capital, which I call relative capital. Such calculations can serve a useful preliminary diagnostic role before engaging in deeper and more detailed explorations of the fundamental determinants of differences in income per worker. If differences in physical and human capital -- or capital gaps -- are sufficient to explain most of the difference in incomes, then researchers and policy makers need to focus on factors holding back investment (in machines and in humans). Instead, if differences in capital are insufficient to account for most of the variation in income, one must conclude that developing countries are also hampered by relatively low efficiency at using their inputs - efficiency gaps. The research and policy agenda would then have to focus on technology, allocative efficiency, competition, and other determinants of the efficient use of capital.

I find that on average the Latin America's overall physical and human capital endowment relative to the USA is essentially identical to Latin America's efficiency relative to the USA . For example in my main sample sample average relative capital and average relative efficiency are both 44% - or roughly double actual average relative incomes. Hence, both capital gaps and efficiency gaps are very large: the average Latin American country has less than half the capital (human and physical) per worker of the US, and uses it less than half as efficiently.

In assessing this evidence, it is essential to bear in mind that efficiency gaps contribute to income disparity both directly -- as they mean that Latin America gets less out of its capital -- and indirectly -- since much of the capital gap itself is likely due to diminished incentives to invest in equipment, structure, schooling, and health caused by low efficiency. The consequences of closing the efficiency gap would correspondingly be far reaching.

Explaining the Latin American efficiency gap is therefore a high priority both for scholars and for policy makers. It is likely that this task will require firm-level evidence. Firm level evidence would also be invaluable in checking the robustness of the development-accounting results, which are subject to severe data-quality limitations.

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