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Resilient Growth, Persisting Inequality: Identifying Potential Factors Limiting Shared Prosperity in the Dominican Republic

Francisco Galrão Carneiro, Aleksandra Iwulska,
José-Daniel Reyes, and Miguel Eduardo Sánchez-Martín.

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Abstract:

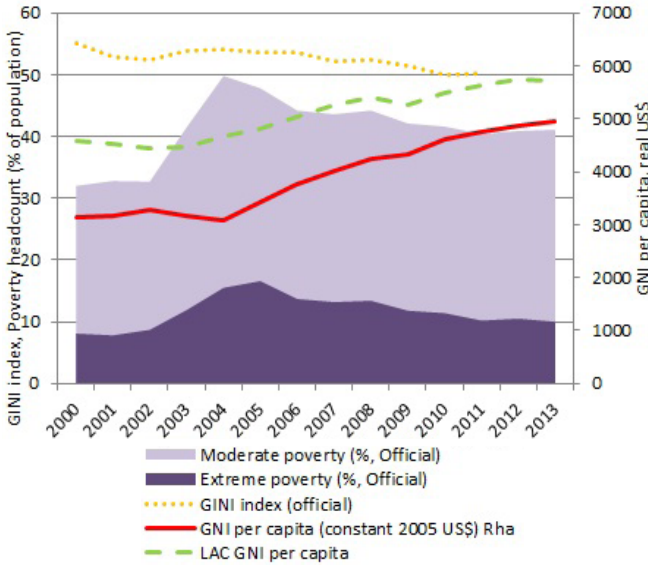
The Dominican Republic (DR) has recorded exceptional growth over the past twenty years and has closed the gap with the Latin America and Caribbean (LAC) region. While in the early 90's the DR´s per capita income was only about 57% that in LAC, it has climbed to around 90% nowadays. However, the country's ability to reduce poverty and improving equity has been less stellar. This note presents some stylized facts of the DR economy that might help understand this phenomenon. In doing so, the note addresses the following three questions: (i) Has growth been inclusive in the DR?; (ii) Why has the DR economy grown so rapidly?; and (iii) Why has growth not led to further improvements in equity? This note tentatively argues that some potential factors explaining the latter are the decline in real wages despite increasing productivity, special economic zones that are relatively isolated from the rest of the economy, and the State's limited capacity for fiscal redistribution.

Growing Strongly but not always Inclusively

The Dominican Republic has enjoyed one of the strongest growth rates in Latin America and the Caribbean over the past 20 years. Between 1992 and the year 2000, the Dominican Republic economy grew at an average rate of 6.7 percent per annum, being the top performer in the region. In the period 2001-2013, growth remained high at an average rate of 5.1 percent per cent, placing the Dominican economy in 4th place in the group of top growth performers (after Panama, Argentina and Peru). This overall dynamic growth has enabled a convergence of the DR's GNI per capita (US$4,959 in 2013[2]) with that of the region, from 57 percent in 1992 to 90 percent of the regional average in 2013. The country also weathered the global economic slowdown of 2008-09 well, but declining domestic demand and a weak performance in richer economies contributed to slow down growth in the DR since 2011 – GDP growth dropped by almost half, falling from 7.8 percent in 2010 to 4.1 percent in 2013.

In spite of this remarkable economic performance, growth has not been inclusive. In 2000 poverty incidence in the Dominican Republic was below the regional average: one in three Dominicans had less than US$4 per day, compared to 42 percent in Latin America and the Caribbean (LAC). In the wake of the banking crisis of 2003-04, the country's GDP that had grown by 6 percent in 2002 contracted by 0.3 percent in 2003. As a result, an estimated 1.7 million people moved into poverty and the poverty rate reached 50 percent of the population in 2004 (up from 32 percent in 2000). When the economy recovered after the crisis, poverty rates began to fall but have not returned to the pre-crisis level (see Figure 1)[3], and it would be nowadays above the average for LAC[4]. At the same time, it is worth noticing that inequality improved between 2000 and 2011 (with the GINI index falling from 0.549 to 0.502). There is also evidence that income growth in the lower quintiles has been faster than in the richer strata of the population between 2004 and 2011; yet, this has been insufficient to compensate for the effects of the 2003 crisis, which disproportionately affected the poor. Another important characteristic of the DR is the limited upward economic mobility. Over the past decade, just under 2 percent of the population in the DR moved up in the income ranks (e.g., from vulnerable to middle class), in contrast to 41 percent in the LAC Region (World Bank, 2014a), which is a striking fact in light of the rapid increase in the country's GNI per capita.

Figure 1: Fast growth in income per capita versus slowly declining poverty and inequality in Dominican Republic.



Source: The Central Bank of Dominican Republic, World Development Indicators and SEDLAC.

Note: Poverty line used for the calculation is the level of $4 PPP per capita per day.

Why Has the Dominican Economy Grown so Rapidly?

Which factors have contributed to the exceptional growth performance in the Dominican Republic? From a sector perspective, the country has undergone a structural transformation where manufacturing and agriculture lost relative importance in relation to tourism and other tradable services. In the early 1970s, agriculture accounted for 21 percent of total output, followed by 22 and 24 percent for manufacturing and services respectively. By contrast, in 2013, services accounted for more than half of GDP while manufacturing accounted for 20 percent and agriculture 8 percent. Since 2000, services have contributed on average 3 percentage points to GDP growth, while manufacturing has contributed only 0.7 percentage points and agriculture 0.3 percentage points. Bussolo et al. (2011) point to the fact that long-term growth in the DR in the past three decades has been driven by integration with the global economy and changes in its export basket. Over this period, the DR shifted from exporting primarily agricultural products to export products with higher value added (footwear, surgical equipment) and services, in particular tourism.

"For most of of the past six decades, growth in the DR has been mainly driven by investment". In the 1990s, the capital stock contributed 4.8 percentage

[2] GNI per capita, Atlas Method. World Development Indicators.

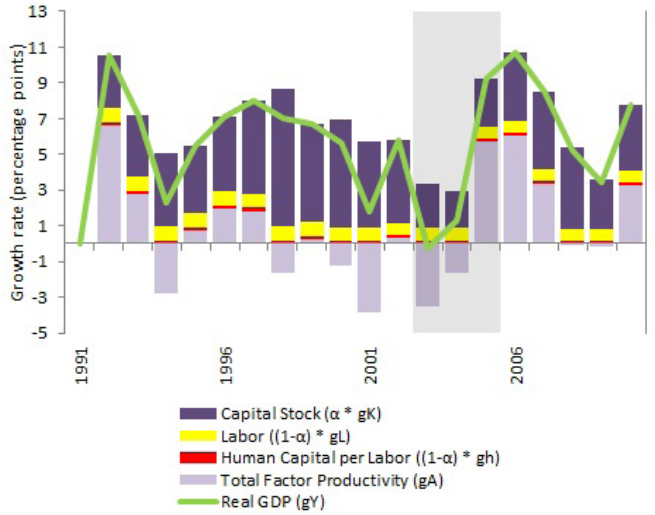
[3] World Bank, 2014a. "When Prosperity is not Shared: the Puzzle of the Weak Links between Growth and Equity inDominican Republic". Equity Assessment, the World Bank.

[4] See SEDLAC. http://sedlac.econo.unlp.edu.ar/eng/statistics-detalle.php?idE=34

points to growth, followed by a contribution of 3.6 percent in the 2000s. Similarly, following Guzman and Lizardo (2003) capital stock contributions to growth haves been in excess of 3.5 percentage points since 1950, and reached more than 6.7 percentage points in the 1980s. Contributions from labor did not exceed 1 percentage point in the past two decades, while contributions from human capital were marginal at 0.2 percentage points.

Guzman and Lizardo (2003) estimated three independent models (Solow; Mankiw; Hall and Jones) and concluded that in most of the 1970s and 1980s Total Factor Productivity (TFP) growth had been negative (-3.6 percentage points in 1974-79; -1.8 percentage points in 1979-91 using the Solow model). Positive productivity contributions to growth, observed in the early nineties and the second half of the past decade, are a relatively new phenomenon. Positive changes in TFP in the early nineties could be attributed to the expansion of an initially successful Special Economic Zones (SEZs) model, with foreign firms establishing subsidiaries. Paradoxically, improvements in productivity after 2004 (the year in which trade preferences in textile expired) are likely to be related to the need of reconversion in these SEZs; this implied a reduction in the number of workers employed and the introduction of more sophisticated machinery to keep productivity up and diversify into products with higher value added in a context of increasing global competition.

Figure 2: Growth Accounting for the DR Economy between 1991 and 2010



Source: Authors calculations using data from World Development Indicators.

Note: The sample period ends to 2010 due to limitations in schooling data. The chart uses the Solow growth accounting model with human capital. Growth accounting involves decomposing the growth rate of total output into growth rates of factor inputs (capital, labor, and human capital) and a residual (growth in GDP unexplained by observed increases in factor inputs). The latter is taken to represent increase in productivity, known as Total Factor Productivity (TFP). $\Delta \ln At = \Delta \ln Yt - \alpha \Delta \ln Kt - (1-\alpha)\, \Delta \ln Lt - (1-\alpha)\, [\Phi \Delta St]$, where A, Y, K, L, and S represent total factor productivity, GDP, physical capital stock, labor force, and average years of schooling. Following Guzman and Lizardo (2003), we consider α=67%.

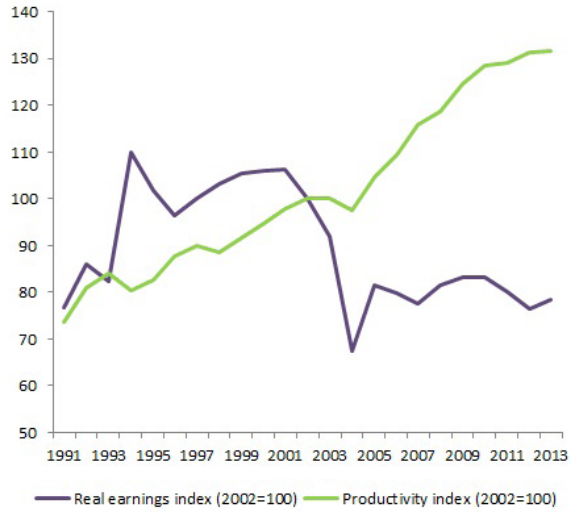
Why Has Growth Not Led To Better Equity Outcomes?

The combination of high economic growth and stubborn poverty rates remains a puzzle, but this is not a phenomenon unique to the DR. Some of the characteristics of the DR economy that may help explain why poverty has not fallen faster in spite of rapid growth are discussed below, including: (i) rising productivity and stagnant real wages; (ii) the enclave nature of the economy; (iii) and the lack of redistributive capacity of the state.

Rising productivity and stagnant real wages

Real earnings declined after the financial crisis of 2003-04 and have not returned to their pre-crisis level, despite significant productivity gains. Real earnings per hour fell to RD$10.3 in 2004 and only recovered nine years later to reach RD$12 in 2013, compared with an average of RD$16 over the 2001-2002 period (Figure 2). In fact, real earnings fell and/or remained stagnant in all sectors, including manufacturing as well as transport and communications, where productivity has grown since 2002 (Abdullaev and Estevão 2013)[5].

Figure 3: Real earnings index and productivity (output per worker) index, 2002=100, 1991-2013



Source: The Conference Board Total Economy Database and authors calculation based on the Central Bank of the Dominican Republic.

After 2004, some of the sectors that contributed the most to GDP growth (manufacturing, telecommunications and financial services) have not produced as many jobs and their shares in employment remain low (Abdullaev and Estevão, 2013).[6] In fact, the share of manufacturing jobs in total employment has almost halved, declining from 19 percent in 1996 to 10 percent in 2013, which partly explains productivity increased in the

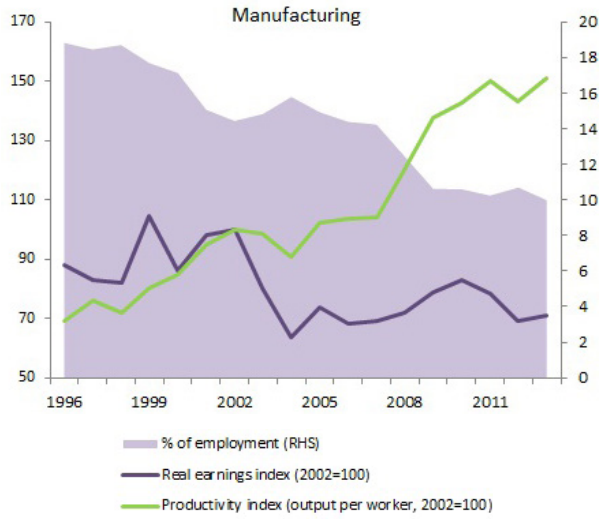
[5] It needs to be underlined that measuring productivity as output per worker (as in this note) or as output per hour (as done by Abdullaev and Estevão) leads to similar results.

[6] We would like to note, though, that gains in productivity in manufacturing (Figure 3) may be also impacted by reduction of manufacturing employment in the SEZs in the 2000s, although Abdullaev and Estevão (2013) use output per hour as a proxy and obtain similar results.

sector (which has moved to relatively more capital intense activities). On the other hand, financial services and the insurance sectors are still small, and employ only 2.6 percent of the workforce. In 2013, the mining sector emerged as a potential driver of economic growth with a contribution of almost 1 percentage point to growth. Yet, the sector hires less than one percent of all employed Dominicans.

On the other hand, the sectors in which employment expanded faster created mostly unskilled jobs (retail and wholesale trade, hotels and restaurants, and other services). For instance, since 2002 retail and wholesale employed, on average, one in five Dominicans. The percentage of jobs in hotels, bars and restaurants with respect to total employment increased from 5.2 percent in 2002 to 6 percent in 2013, but productivity increased only by 13 percent in the same period. Other services (such as housekeeping and certain self-employment activities) have gained on importance, employing 1 in every 4 Dominicans, compared to 1 in 5 Dominicans in 2000. This trend is reflected in labor market outcomes, as unemployment rates remain lower among the least educated. As of April 2014, for example, the working age population with no education level recorded an open unemployment rate of 2.4 percent while the population with primary, secondary, and tertiary education registered unemployment rates of 4.8, 8.7, and 8.4 percent, respectively.[7] As it can be observed in Figure 3, real wages have been stagnant (and much lower than a decade ago), in spite of rising productivity trends.

Figure 4: Rising productivity and declining real earnings per hour in two sectors: 1996-2013.



Source: World Bank staff estimations based on Central Bank of the Dominican Republic.

The stagnation of real wages prevents the lower strata from getting out from poverty. One of the possible reasons for this disconnect between productivity growth and real wage levels can be attributed to rising informality in the labor market, at least in the most low-skill and labor-intensive sectors. Informality levels have increased slightly between 2004 (54 percent) and 2013 (56 percent), in spite of the effective establishment of the social security system. This may have to do with the fact that a large proportion of the new jobs have been created in low value added services (housekeeping, petty commerce), often as a result of self-employment. Informal workers in the DR are a very diverse group, and informality is widespread across sectors (Guzman, 2007). Some of the workers are forced to accept informal contracts, while some small business owners do not register their businesses because they find it burdensome and costly, in particular those that do not plan to expand their businesses in the future. This may negatively impact productivity, as business fragmentation due to informality may prevent the attainment of economies of scale.

In addition, high levels of informality push people outside of the social security safety nets, strip the state from potential tax resources and limit their participation in organized workers unions. The historical weakness of labor unions in the Dominican Republic (Ondetti, 2009) may partly explain the observed decrease in the real return to labor, despite the rising productivity, as they do not enjoy a strong bargaining position vis-à-vis entrepreneurs when negotiating minimum wages; at the same time, in a context of rising real exchange rates in the aftermath of the crisis of

[7] Open unemployment rates consider only respondents that have declared to be actively looking for a job over the previous month. It is worth noticing that labor market participation rates among individuals with tertiary and (77 percent) and secondary (64 percent) education are significantly higher than those with primary or none education (around 50 percent). Source: ENFT survey of the Central Bank of the Dominican Republic.

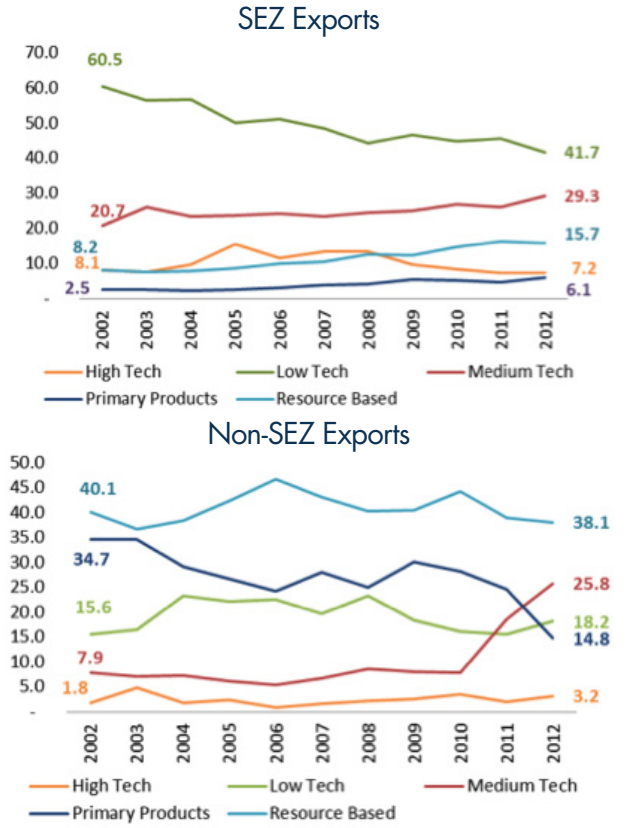
2003, keeping wages down may have been the only way to continue attracting FDI and preserving external competitiveness.

Finally, it has often been argued that the arrival of Haitian migrants could be the source of an excess supply of unskilled labor that would pressure wages downward. However, evidence on this hypothesis is inconclusive. On the one hand, Aristy-Escuder (2008) argues that the Haitian workforce is a substitutive for the unskilled Dominican workers, resulting in a wage reduction for less-qualified jobs, whereas return to capital and wages of the skilled workforce are increased. On the other hand, Mejía (2009) finds some evidence that native workers in the construction sector of the Dominican Republic are currently more affected by unemployment than Haitians, although he does not find strong evidence of deterioration in sector wages provoked by the increased participation of migrants in the workforce. Finally, the World Bank (2012) also finds only weak evidence of downward wage pressures caused by Haitian workers.

An enclave economy with weak linkages

The disconnection between high value-added sectors (with limited job generation) and low value-added sectors (with informality and high employment growth) is a symptom of a divided economy, evident also in the structure of exports. Firms operating under Special Economic Zones (SEZ) produce and export higher value-added products when compared to exporters that are subject to the national regime. The former group specializes in sectors such as clothing, medical devices, and jewelry whereas the latter group specializes mostly in resource-based products, such as minerals (gold, ferronickel) and agricultural products (Figure 4). On the surface, the Dominican export basket looks well diversified in terms of products, but only a handful of goods are really meaningful in terms of export value. Manufactured products that require some level of industrial transformation typically come from SEZs: medical instruments, cigars, electrical circuit breakers, and T-shirts.

Figure 5: Technological composition of exports.



Note: These figures show the evolution of the technological content of Dominican Republic's exports using the classification suggested by Lall (2000).
Source: World Bank (2014b), a Trade Competitiveness Diagnostic for the Dominican Republic.

Exports and employment in Special Economic Zones fell dramatically during the past decade, in the context of expiring textile preferences. In the beginning of the 2000s, Dominican exports were dominated by textile exports (that accounted for a third of total exports) when the clothing industry received benefits from the US quotas defined by the global Multi-Fiber Agreement (MFA), which had been in place for over three decades. The phasing out of the MFA, completed at the beginning of 2005, led to a decline in the textile industry in the DR which was unable to compete with cheaper clothing from China, Hong Kong, Vietnam, and Bangladesh. Faced with the phase-out of the MFA, the DR was a latecomer to the CAFTA agreement – a free-trade agreement between the Central American region and the US – joining it in 2007. Since then, SEZs have been able to diversify the export basked into emerging products such as medical devices, footwear, and pharmaceuticals. However, this transformation has not brought net employment creation, as jobs in SEZs fell from 140 thousand in 2000 to just about 40 thousand in 2012.

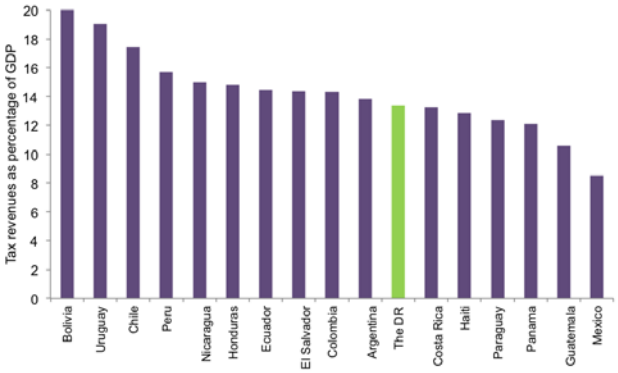
Another challenge of the SEZs is that they constitute "enclaves" that are relatively isolated from the rest of the economy, reducing the potential for positive externalities and spillovers. The literature on SEZs in the Dominican Republic (Burgaud and Farole, 2011; Sánchez-Ancochea, 2012) discusses at length the lack of backward linkages, although direct evidence is scant. Employing enterprise surveys, the World Bank (2014b) finds that Dominican FDI enterprises (most of them located in SEZs) import almost 70 percent of their inputs, compared to 49 percent in the Caribbean, 58 percent in Central America, and 43 percent in South America and Mexico.[8] SEZs are not buying inputs from domestic suppliers, which limits the potential for knowledge transmission, learning by doing processes and efficiency gains. Another tentative interpretation is that the lack of linkages with the rest of the economy may also indicate that most of the wealth generated in the export process remains in SEZ companies that are usually foreign owned.

Summarizing, fewer jobs and downward pressures in SEZ wages, as they try to adapt in a context of increased international competition and end of trade preferences in textiles would have limited the prospects for shared prosperity in the country, in a moment of rising income and productivity. At the same time, lack of backward linkages of foreign owned firms in SEZ's to the rest of the economy would limit the transmission of productivity gains to local producers.

Limited redistributive capacity of the Dominican state

The third possible explanation for slow improvements in inequality and poverty reduction in a context of high growth rates is the limited fiscal space the Dominican Republic counts with to conduct equity-enhancing public policies. On the tax side, for example, the Dominican Republic is characterized by limited revenue generation capacity and underperforms in relation to other countries in Latin America and the Caribbean in terms of revenue generation (Figure 5). Tax revenues have declined from an average of 15.1 percent of GDP in 2005-2008 to an average of 13.3 percent of GDP in 2009-2013.This is mostly explained by the dismantling of tariffs and duties in the context of the DR-CAFTA agreement. It is also worth noting that the Executive has unsuccessfully tried to prevent the decline in fiscal revenues by adopting a total of six tax reforms between 2004 and 2012. One of the most significant measures (in terms of revenue collection capacity) introduced was the increase in VAT rates from 12 percent to 16 percent (law 288-04) and then 18 percent (law 253-12), which is likely to have been moderately regressive.[9]

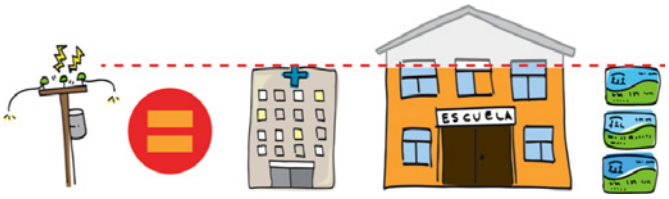
Figure 6: Tax revenues as percentage of GDP in LAC in 2012



Source: CEPALStat.

On the expenditure side, a series of rigidities limit the fiscal space to conduct redistributive policies. First, the crisis of 2003 had a large fiscal cost, associated to the bailout of one of the main financial entities of the country, and the State has been devoting since 2007 around 1 percent of GDP to the recapitalization of the Central Bank. Second, while the Dominican Republic non-financial public sector debt stock declined from around 29 percent of GDP in 2003 (following the crisis) to 18 percent in 2007, it has expanded again, reaching 38.3 percent of GDP in 2013. The IMF[10] has recently alerted about the large public gross financing needs the Dominican Republic is facing in 2014, representing around two thirds of expected revenues. A third rigidity is that caused by inefficiencies in the electricity sector (see Rufín et al, 2014), which have entailed government transfers averaging 1.3 percent of GDP in 2009-2012, and pose also a severe burden for the competitiveness of Dominican companies (Figure 6).

Figure 7: The opportunity cost of transfers to the electricity sector in the Dominican Republic, 2012



Note: Transfers to the electricity sector in 2012 represented close to two thirds of final spending on education, the entire public health budget, and three times the cost of social subsidies.
Source: author's elaboration.

[8] The authors look at the Dominican FDI companies (defined as those with a percentage of foreign ownership above 10% of social capital) by using World Bank-IFC Enterprise Surveys. The Dominican survey sample consists of only 57 observations; hence, the results should be interpreted with caution.

[9] According to micro-simulation exercises conducted by the Ministry of Economy, Planning and Development, with the support of the World Bank, in January 2013.

[10] IMF Executive Board Concludes 2014 Article IV Consultation and Second Post-Program Monitoring Discussion with the DR. Press Release No. 14/281. Accesible at http://www.imf.org/external/np/sec/pr/2014/pr14281.htm

With limited fiscal space, the Dominican Republic has kept its public spending on social sectors at a low level, compared with the rest of the region. Over the period 1991-2010, the DR spent just around 2 percent of GDP on public education, ranking at the bottom of Latin America[11]. While there has been a notable expansion in school enrollment over the past two decades, the system has been characterized by high student-to-teacher ratios, double shifting by teachers, inadequate formation, and high repetition and drop-out rates (Sánchez and Senderowitsch, 2012). In order to address these challenges, and following wide citizen protests that took place in December 2010, the government increased allocations for education to 4 percent of GDP for the first time in the 2013 budget. The health sector presents a similar situation, having registered notable improvements in terms of coverage, but facing some persistent challenges in terms of effective access, as private out of pocket expenditure still represents 66 percent of total spending, and acquiring medicines is a heavy burden for the poorer strata of the population.

In sum, there seems to be a vicious cycle that limits the capacity of the Dominican State to redistribute wealth. Sánchez and Senderowitsch (2012) observe how individuals in the Dominican Republic, especially among the middle class, opt out from public services in the light of their limited quality, choosing instead private solutions (for example, private schools, private health insurance). This seems to make them less likely to engage in collective action demanding increasing accountability from the public sector, and less inclined to pay taxes, thus further limiting state resources to improve the quality of public service delivery. This low level equilibrium is likely to be preventing the attainment of a welfare state in the country, and hampering prospects for poverty and inequality reduction.

[11] SISDOM, Ministry of Economy, Planning and Development of the Dominican Republic, and World Development Indicators.

Conclusion

The fact that growth has been less inclusive than one would have expected for an economy that is growing fast is not a Dominican phenomenon. It is actually not uncommon to see countries with high growth rates and yet with limited improvements in poverty (see Donaldson, 2008, for a list of "underperformers"). What is true in the case of the DR is that some of the stylized facts discussed above seem to represent important constraints to inclusive growth. As of 2011, one in three people in the DR have been unable to generate incomes above the poverty line despite having some basic skills and assets to generate higher incomes (World Bank, 2014a). That inability to take up good economic opportunities and convert them into higher income and standards of living is what needs to change in the DR so that growth can benefit more people in the country.

This note has highlighted some potential explanations to the Dominican puzzle. Firstly, the economic slowdown of 2003 combined with the end of textile preferences in 2004 resulted in a sharp decline in employment in manufacturing, and required a reduction in real wage levels to keep the competitiveness of DR manufacturing exports; since then, wages have remained stagnant, in spite of increasing productivity. In addition, employment creation has been taking place mainly in sectors with lower value added, such as hotels and restaurants, and other services (where informality prevails). These two factors combined result in lower prospects for poverty reduction in the country. Ongoing conversations about revamping the 1992 labor code could be a good opportunity to discuss the broken link between productivity and salaries.

Secondly, and related to the previous point, Special Economic Zones are moving towards products with higher value added (footwear, surgical equipment), but job creation is still limited, and linkages with the rest of the economy remain weak; this limits the potential for productivity improvements through spillovers to firms outside special economic zones. Efforts in terms of capacity building for small and medium Dominican companies may be needed for them to become reliable suppliers of multinationals in SEZ's. This would help increasing the scope for nationwide productivity improvements, and could potentially lead to employment creation.

Third, the Dominican Republic has traditionally counted with limited fiscal space for redistributive policies, since tax collection is low (partly due to existing exemptions and low citizen trust in public institutions), and electricity and debt service introduce rigidities on the expenditure side. Recent efforts to allocate 4 percent of GDP to public education are commendable, and likely to result in more opportunities for the poor, especially if social expenditures are increasingly better targeted. Countries like Brazil complemented the effects of growth on poverty reduction through active redistributive policies, which has not happened in the DR despite more recent efforts to create conditional cash transfer (CCT) programs and target some of their existing subsidies. In the DR, as is the case in general, redistributive policies will need to be accompanied by policies aimed at ensuring the quality of public services for all, as well as measures ensuring the sustainability of public finances.

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