Abstract

This paper highlights the importance of institutions on development and as it particularly applies to Colombia. It provides some evidence that the institutional environment in which an economic activity takes place is an important determinant of growth. It suggests that countries with high levels of economic growth are characterized with high levels of economic freedom and judicial efficiency, low levels of corruption, effective bureaucracy, and protected private property.

Resumen

Este escrito destaca la importancia de las instituciones en el desarrollo y en la manera como esto se aplica particularmente a Colombia. Provee alguna evidencia de que el ambiente institucional en el cual la actividad económica ocurre es un determinante importante del crecimiento. Sugiere, además, que países con elevados índices de crecimiento se caracterizan por altos índices de eficiencia judicial y libertad económica, bajos niveles de corrupción, una burocracia eficiente y protección a la propiedad privada.

Keywords
Institutions, Economic Freedom, Economic Policies, Corruption, Decentralization, Credibility and Transparency

Introduction

The institutional settings within which economic policies are formulated are of crucial importance, and the quality of these institutions can be a primary source of the differences in economic growth among nations. Clague, Keefer, Knack, and Olson (1996) indicated that the quality of economic policies and institutions vary from one dictatorship to another and from one democracy to another, and therefore irrespective of the type of the political regime will have a substantial impact on growth. North (1990 and 1991) suggested that institutions shape the incentive structure that may impede or increase economic activity. Poor institutions interfere with economic growth by inducing economic agents to engage in redistributive politics rather than economic activity with lower economic returns (Murphy, Schleifer, and Vishny 1991). Hall and Jones (1997) argued that poor institutions encourage diversion over production and therefore reduce the level of economic activity. Among the relatively recent empirical
and theoretical research on institutions and economic growth are Acemoglu (2005), Acemoglu, Johnson, and Robinson (2001, 2002), and Aoki (2000, 2001).

Philip Lane and Aaron Tornell (1996) observed that many countries that are rich in natural resources such as Nigeria, Trinidad and Venezuela have done badly in terms of economic growth because natural resources suffer from a common-pool problem. In the absence of well-defined and protected property rights, natural resources can be exploited by a number of powerful political interest groups. Poor countries tend to have unreliable legal systems, corrupt governments and insecure property rights. The lack of the security of property rights also prevents poor countries from acquiring the badly needed, advanced and expensive technology available in developed countries.

This paper highlights the importance of institutions and their effects on growth and development. The rest of the paper is organized as follows: section II addresses the effect of political regimes on development. The debate of whether the nature of political regime (democracy vs. dictatorship) matters for growth is unsettled. This section provides the claims and counter-claims of whether democracy is a pre-requisite for a country’s economic development. Section III underlines the importance of institutions, while section IV concludes and provides suggestions for further research. While the paper addresses these issues in a more generalized fashion, nevertheless, an attempt will be made to draw attention to the relevance of institutions for the future of Colombia. Section III specifically tries to show the political and policy implications of institutions and institutional quality for the betterment of Colombia.

Does the Nature of the Political Regime Matter? Or is it All About Institutions?

Institutional scholars argue that the quality of institutions matter more than the type and the nature of the political regime. They suggest that the quality of institutions will have a lasting impact irrespective of a country’s political orientation. Dictatorships with good institutions such as Singapore, and Chile under Pinochet, succeeded economically while many democracies are economically backward. Natural resource-rich countries such as Nigeria, Venezuela, and the Democratic Republic of Congo have done poorly in terms of economic growth while resource-poor countries in East Asia such as Hong Kong, Taiwan, Singapore and South Korea grew fast in the past 30 years. For example, South Korea had the same per capita income as Congo in 1960; today, it is ten times richer and all the indications suggest that it was all about the characteristics of their respective institutions.

Although the quality of institutions can be of utmost importance in a country’s economic trajectory, it might also be the case that the type of the political regime is also as important as institutions. There is a voluminous literature on the effect of democracy on growth. The overwhelming conclusion of this literature is that democracy and all that it entails is a pre-requisite for economic development. The proposition that democracy promotes growth is based on the premise that democratic regimes provide constitutional guarantees of the protection of property rights: a legal framework that facilitates exchange and enforces contracts. Proponents of this idea suggest that democratic processes and the existence of fundamental civil rights and political freedoms create an environment conducive to investment, and the requisite incentives to undertake risky economic activity (Scully 1988 and 1992). The economic collapse of the socialist totalitarian regimes in the early 1990s and their shift towards democratic, free market systems support this claim.

However, a stark contrast to this proposition is the conflict perspective whereby democratic regimes are vulnerable to popular pressures. Voter preferences for current consumption over long-term investment make democracies ill equipped to undertake the kind of policies necessary for sustained economic growth. Pressure groups in democracies hobble the enactment of policies whereby current consumption activities are sacrificed for long-term investment. Pranab
Bardhan (1993), Przeworski and Limongi (1993) and Weede (1983) suggest that development-minded authoritarian regimes are characterized by a high degree of insulation from short-term, pork-barrel politics. They also report that the ability to insulate institutions from redistributive politics allowed East Asian non-democratic, resource-poor countries to grow faster than comparable democratic countries.

Dictators as residual claimants to national wealth may also have an encompassing interest in promoting economic growth (Olson 1991, and McGuire and Olson 1996). In addition, Dore (1978) argues that dictators promote growth not out of concern of the welfare of citizens, but to enhance their status among world leaders, if in effect personal prestige is a positive function of national wealth.

The proponents of the authoritarian approach to economic growth generally believe that democracy poses a real threat to economic development; whereas an insulated non-democratic regime promotes growth especially during the earliest stages of economic development. Historical evidence suggests that genuine democracy did not exist in any of the developed countries during several stages of their economic development.

Whatever cogent theoretical reasons may be given in support of one perspective or another, the empirical results do not clarify the issue one way or the other: Economic growth can take place in a democratic environment; it can also take place in a dictatorship provided that economic agents are allowed to fully exploit their human potential. For example, a highly democratic country with a wide range of political freedoms and civil liberties may adopt economic policies that discourage entrepreneurship and investment. Alternatively, autocratic regimes may adopt economic policies that promote basic economic freedoms, and encourage investment and private initiatives.

Good Institutions as a Pre-requisite for a Better Colombia

As an economist, let me start with a caution. It is very likely that the transition of Colombia from authoritarianism, military junta, drug war, guerilla insurgency, to a broad-based democracy will coincide with severe economic hardships. How successful Colombia will be will depend on the institutions established and the policies followed. Although many external factors outside the control of Colombian political elites will affect the outcome, in this paper, I will emphasize those institutions and economic policies, which I think are under the purview of Colombia’s current political leaders and which I think will contribute to the consolidation of the transition and to good economic performance. Chief among these are: political freedom and civil liberty, economic freedom (distinct from other freedoms), judicial efficiency and the rule of law, political credibility, stable economic policies, a transparent political system, decentralization of power, and an accountable and responsive state institutions.

Guaranteeing freedom, formulating credible and stable policies, and establishing transparent, decentralized, and accountable state institutions will determine the outcome of Colombia’s political and economic future. Colombia can therefore be the vibrant Singapore in Latin America or it could be another economic basket case similar to its immediate neighbor in the East, Venezuela. The economic potential is there, the question is whether the complementary political will of unleashing this potential is available in the current crop of Colombia’s political leaders. The choice is theirs; it is also the Colombian people to live with the consequences of the choices they make. Here are few of the institutional variables that are deemed to be extremely important and really quite necessary for political and economic progress. The list is not exhaustive and could not be satisfactorily addressed in this short paper.

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1 Universal suffrage as an institutional arrangement determining the political outcome did not exist in the US. Women were not allowed to vote before 1920, and even then blacks were not allowed to cast their votes in some southern states.
I. The Rule of Law

The rule of law in any given country reflects the degree to which the citizens of that country are willing to accept the established institutions to make and implement laws and adjudicate disputes. It also indicates the extent to which countries have sound political institutions, strong courts and orderly succession of powers. A good measure of how reliable a country’s legal system is the extent to which a government enforces the rules codified in their constitutions. In many developing countries including Colombia, it doesn’t take much for a government to repudiate its contract with the citizens of the country. In extreme cases, citizens face risks associated with arbitrary arrests, summary executions, outright confiscation, and forced nationalization of private property. Another burden that citizens of rogue states face is the poor quality of the government bureaucracy. Often times, the bureaucracy is incompetent and lacks professionalism. Moreover, the government employees are recruited and promoted not by merit but rather on political, tribal, or clan loyalty. In developed countries, the bureaucracy is not only competent and highly proficient, but it is also autonomous and free from political pressure.

The quality of the bureaucracy can be measured by the strength and expertise to which it conducts its activity without drastic changes in policy or interruptions in government services. It can also be measured by the extent to which high government officials are likely to demand special payments, and the extent to which legal claims are adjudicated without paying someone for the services that should have been provided for free.

### TABLE I

**CORRUPTION PERCEPTION INDEX IN SELECTED LATIN AMERICAN COUNTRIES**

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<tr>
<th>Countries</th>
<th>1998</th>
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<td>Bolivia</td>
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<td>Ecuador</td>
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<td>Venezuela</td>
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<td>2</td>
<td>1.9</td>
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<tr>
<td>Paraguay</td>
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</table>

Source: Transparency International

Table 1 above indicates the level of corruption in Latin America from 1998 to 2005. The index relates to perceptions of the degree of corruption as seen by business people and country analysts and ranges between 10 (highly clean) and 0 (highly corrupt). As the table indicates, Colombia fares worse than Chile, Uruguay, Brazil, and Peru. However, it fares better than its immediate neighbors Venezuela and Ecuador. The average score of Colombia is a paltry 3.4 out of a total score of 10. This means that Colom-
Colombia is perceived as a highly corrupt country. However, in relative terms, Colombia is not as bad as some African and Asian countries. The measure of corruption perception in Colombia has also consistently improved through the years. For example, in 1998 Colombia was considered as one of the most corrupt countries in the World. It ranked 79 out of 85 countries in which data was available. Only Indonesia, Nigeria, Tanzania, Honduras, Paraguay, and Cameroon fared worse than Colombia. By 2005, Colombia ranked 56 out of a total of 158 countries in which data was available; 55 countries performed better than Colombia.

Figures 1 & 2 below are scatter plots of Colombia versus Chile and Venezuela. Chile consistently ranked at the top while Venezuela consistently ranked at the bottom. However, there is a huge gap between Chile and Colombia and there is a room for improvement for Colombia in the next few years. The trend line of Colombia is sloping upward and that is a good sign that finally Colombia is on the right path.
The most important thing that a government can give to its own people is to protect and endow them with their god-given freedoms. Of fundamental importance are political freedom and civil liberties. Whether a government provides political freedom to its citizens will depend on how it responds to the following questions:

1. Is the head of the state elected through free and fair elections? Are legislative representatives elected through free and fair elections? Are there fair electoral laws, fair polling and honest tabulation of ballots? Do the people organize freely in different political parties or other political groupings of their choice? Is there significant opposition vote and realistic possibility to gain power through elections? Does the country have the right of self-determination and its citizens free from any kind of domination? Do cultural, ethnic, religious and other minority groups have reasonable self-determination? Is the political power decentralized?

In addition to political freedom, the civil liberties of the citizens should also be protected. Among other things, the following questions also address the extent to which citizens fully enjoy liberties of civilized societies. Is there open public and private discussion? Is there freedom of assembly and demonstration? Is there freedom of political organization? Are citizens equal under the law and have access to an independent, non-discriminatory judiciary? Is there a protection from imprisonment and exile? Are there free and independent media, literature and other cultural expressions? Are there free trade unions and peasant organizations or equivalents? Are there free professional and other private organizations? Are there free businesses or cooperatives? Are there free religious institutions? Are there personal and social freedoms such as freedom of movement, choice of residence, and choice of citizens to engage of marriage and size of family? Is there equality of opportunity? And finally, is there a freedom from extreme government indifference and corruption?

The Freedom House publishes a survey of the status of the Freedom in the World. This is a standard-setting comparative assessment of global political rights and civil liberties published annually since 1972. In this survey, countries are ranked either as free, partially free, or unfree. Colombia is recently ranked as partially free and is also considered as one of the countries at the crossroads in the year 2007. Freedom House commented:

"In Colombia, President Alvaro Uribe’s 2006 reelection victory, which followed a constitutional change in 2005 allowing him to run for a second term, was approved by international observers as free and fair. However, later in 2006 information emerged that seemed to provide proof of long-rumored links between paramilitaries and government officials. Subsequent investigations discovered paramilitary influence in the Congress, the national prosecutor’s office, the military, and the judiciary, highlighting the threats to the rule of law stemming from Colombia’s ongoing battle with rebel groups. These discoveries detracted from Uribe’s otherwise notable efforts to improve security and contain paramilitary factions, and caused Colombia’s scores to fall somewhat. In order to deal with its internal conflict, the government initiated talks with the National Liberation Army guerrillas and completed the demobilization of 30,000 members of the paramilitary known as the United-Self Defense Forces of Colombia. The demobilization occurred under the terms of the 2006 Justice and Peace law, which offered..."
reduced sentences for former paramilitaries in return for the surrender of weapons and ill-gotten assets. Nonetheless, serious questions remained about the legislation’s perceived leniency and whether prosecutors were given enough time and resources to conduct adequate investigations.”

The relevant questions above narrowly define freedom and did not capture other relevant factors measuring the degree of economic freedom, such as freedom to own and dispose private property, freedom to keep what one earns, and the freedom to exchange and trade. Therefore, it is imperative to define freedom more broadly to include economic dimensions. In the future, the Colombian citizen should be given a real voice in public discourse including economic issues.

Fraser Institute publishes and ranks countries on the level of economic freedom that their respective citizens enjoy. The areas and the components of the economic freedom index included in this survey are shown below in Table 2.

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Table 3 below presents the economic freedom index for most of the Latin American countries. The index is scored in the scale of 1-10; the higher the index the higher the level of economic freedom. As shown in Table 3, Colombia scored second to last, only Venezuela fared worse than Colombia. While Colombia started with a medium level of economic freedom scoring 5 out of 10 in 1975, it scored 5.55 in 2006, a negligible improvement over 30 years. Relatively Chile scored 3.9 in 1975, much lower than Colombia; however, by 2005 it doubled its level of economic freedom to a respectable score of 7.98.

Figures 3 and 4 below compares Colombia’s level of economic freedom to those of Chile and Venezuela; of particular interest here is the recent trend of Chile and Venezuela. While Chile started low and consistently moved up in the ladder of economic freedom, Venezuela started with an acceptable level of economic freedom in 1975 and since then took a downhill turn. It is obvious here that Chile could be a role model for Colombia while it is Colombia’s best interest to avoid the road that Venezuela treaded on recently.

Table 2
THE AREAS AND COMPONENTS OF THE ECONOMIC FREEDOM OF THE WORLD INDEX

<table>
<thead>
<tr>
<th>I: Size of Government: Expenditures, Taxes, and Enterprises</th>
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<tr>
<td>A. General government consumption spending as a percentage of total consumption.</td>
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<td>B. Transfers and subsidies as a percentage of GDP.</td>
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<td>C. Government enterprises and investment as a percentage of GDP.</td>
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<td>D. Top marginal tax rate (and income threshold to which it applies).</td>
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<td>i. Top marginal income tax rate (and income threshold at which it applies)</td>
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<td>ii. Top marginal income and payroll tax rate (and income threshold at which it applies)</td>
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3 For more information on economic freedom, visit http://www.freetheworld.com.
2: Legal Structure and Security of Property Rights

A. Judicial independence: the judiciary is independent and not subject to interference by the government or parties in disputes.
B. Impartial courts: A trusted legal framework exists for private businesses to challenge the legality of government actions or regulation.
C. Protection of intellectual property.
D. Military interference in rule of law and the political process.
E. Integrity of the legal system.

3: Access to Sound Money

A. Average annual growth of the money supply in the last five years minus average annual growth of real GDP in the last ten years.
B. Standard inflation variability in the last five years.
C. Recent inflation rate.
D. Freedom to own foreign currency bank accounts domestically and abroad.

4: Freedom to Trade Internationally

A. Taxes on international trade.
   i. Revenue from taxes on international trade as a percentage of exports plus imports.
   ii. Mean tariff rate.
   iii. Standard deviation of tariff rates.
B. Regulatory trade barriers.
   i. Hidden import barriers: No barriers other than published tariffs and quotas.
   ii. Costs of importing: the combined effect of import tariffs, license fees, bank fees, and the time required for administrative red-tape raises costs of importing equipment by (10 = 10% or less; 0 = more than 50%).
C. Actual size of trade sector compared to expected size.
D. Difference between official exchange rate and black market rate.
E. International capital market controls
   i. Access of citizens to foreign capital markets and foreign access to domestic capital markets.
   ii. Restrictions on the freedom of citizens to engage in capital market exchange with foreigners—index of capital controls among 13 IMF categories.
S: Regulation of Credit, Labor and Business

A. Credit Market Regulations
   i. Ownership of banks: percentage of deposits held in privately owned banks.
   ii. Competition: domestic banks face competition from foreign banks.
   iii. Extension of credit: percentage of credit extended to private sector.
   iv. Avoidance of interest rate controls and regulations that lead to negative real interest rates.
   v. Interest rate controls: interest rate controls on bank deposits and/or loans are freely determined by the market.

B. Labor Market Regulations
   i. Impact of minimum wage: the minimum wage, set by law, has little impact on wages because it is too low or not obeyed.
   ii. Hiring and firing practices: hiring and firing practices of companies are determined by private contract.
   iii. Share of labor force whose wages are set by centralized collective bargaining.
   iv. Unemployment Benefits: the unemployment benefits system preserves the incentive to work.
   v. Use of conscripts to obtain military personnel

C. Business Regulations
   i. Price controls: extent to which businesses are free to set their own prices.
   ii. Administrative conditions and new businesses: administrative procedures are an important obstacle to starting a new business.
   iii. Time with government bureaucracy: senior management spends a substantial amount of time dealing with government bureaucracy.
   iv. Starting a new business: starting a new business is generally easy.
   v. Irregular payments: irregular, additional payments connected with import and export permits, business licenses, exchange controls, tax assessments, police protection, or loan applications are very rare.

TABLE 3
ECONOMIC FREEDOM INDEX FOR SELECTED LATIN AMERICAN COUNTRIES

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FIGURE 3
ECONOMIC FREEDOM INDEX OF COLOMBIA VS CHILE

FIGURE 4
ECONOMIC FREEDOM INDEX OF COLOMBIA VS VENEZUELA
Another important factor that will affect the success of a country’s future state is the quality of the government’s economic policies. Fiscal, monetary, and trade policies will affect the economic environment in which economic activity takes place. One of the fiscal policy parameters that are considered to have a negative impact on economic growth is the size of government. The standard explanation in the literature is that government deficit crowd-out private capital formation by increasing interest rate and reducing the amount of savings available for private investors. To the extent that deficits are used for investment purposes, the country’s total capital formation might not necessarily decline. However, the relative productivity of public and private capital can affect the pace of economic growth and as long as the return to public capital is below that of private capital, deficits will negatively affect the growth rate of the country’s economy. It is therefore necessary to have a small but efficient government. This will minimize the habit of depending the government for things that people can do for themselves. If you create a government big enough to give you everything you need, it would be a government big enough to take everything you have. The future governments of Colombia shouldn’t fall into the trap that the size of your bureaucracy is a reflection of your power.

How about trade policy? The Colombian economy should be open and should follow an outward-looking strategy. Openness is an important determinant of economic growth. The current US government and the US congressional leaders concluded a bipartisan agreement that provided a clear path for advancing free trade agreements, including the agreement with Colombia. The agreement includes strong labor and environmental provisions which are necessary for the Colombian workers. Colombia should capitalize on this agreement and should be fully engaged in international trade.

The future Colombian regimes should work hard to seek broad and diverse markets for their export goods including plantains, sugar crops, petroleum, coal, coffee, and the other natural resources to eliminate the foreign exchange bottleneck of depending exports to US for their livelihood. With the recent improvement of security, Colombia can also develop its tourist industry. The empirical literature on trade overwhelmingly suggest that trading with other nations is a positive-sum game; is mutually beneficial to the trading partners; and is an engine of economic growth and development.

In terms of monetary policy, the most important thing that the Colombian government should do is to protect the value of the Colombian peso. Inflation has been declining since 2004 and is a good indication that the government is on the right track. The recent inflow of export dollars has resulted in substantial reevaluation of the Colombian peso. However, Colombia should strike a balance between keeping the value of the peso and the effect that an overvalued currency could have on its trade balance.

4. Credibility and Transparency

The future Colombian governments should be credible and transparent. Credibility can be provided not by decree but by enforcing the law of the land and abiding by it. In other words, you earn credibility when the government enforces the rules and is bound by them. Having free elections and winning it does not guarantee credibility. You have to earn it and the biggest obstacle to political credibility is an executive with excessive discretionary powers. Therefore, the government should be frugal with its discretionary powers.

The government should also be transparent, and to be transparent it should allow the full freedom of the press and the mass media. Transparency allows the government to sustain its political future. It will allow the government to build a power base not based on clients and individuals but on grass root support. Freedom and good economic policies coupled with transparency and political credibility will guarantee a political success and acceptance from the masses.
5. Decentralization

It is imperative that the power of the state is divided and should not be concentrated in the hands of one individual or one entity. In addition to horizontal separation of powers, the power of the state should also be vertically divided. The idea of decentralization is to establish different hierarchical levels and to distribute the power of the state in a way that creates mutual dependence. By sharing the legislative and enforcement powers with lower levels of government, decentralization will also reduce the pressure on the government to deliver and will allow it to deflect criticism. By decentralizing, you are not only sharing the power with lower level groups but also the responsibility and the blame that comes with it. Although Colombia has a long history of constitutional governments, the concentration of the political and economic power in the hands of the elite minority fuels insurgency and the continent’s longest-running armed conflict.

In a paper co-authored with Hodan Issa and published in Cato Journal, we found that the decentralization of power reduces corruption. The paper addressed the determinants of economic corruption in a cross-sectional study of 119 countries. It found that decentralization and vertical separation of powers reduces corruption and creates multiple veto powers along vertically competing jurisdictions. It makes collusion among corrupt officials difficult to enforce.

Although some commentators and political science scholars might argue that federalism and decentralization of power would perpetuate regionalism, all the indications suggest that the vertical separation of powers protects the sovereignty of the individual and protects individual liberty from self-serving politicians who might otherwise seek the concentration of the political power and would use it to attain pecuniary and non-pecuniary personal and parochial gains.

6. Conclusion

Many empirical results from different countries reveal that countries with high levels of economic growth are characterized by high levels of judicial efficiency, low levels of corruption, effective bureaucracy, sound economic policies, transparent and decentralized political system, and protected private property, among others. The results also indicate that freedom is important for economic development. Economic and political freedoms are symptomatic of good institutions. They go hand in hand, suggesting that freedom can only be sustained in an environment of high institutional quality. Today, Colombia under President Uribe has a window of opportunity to put the future path of Colombia into a good start. Let the journey begin with institutional framework that will guarantee the sovereignty of the Colombian citizen, and I hope the transition to a solid democracy will soon generate substantive economic outcomes for the people of Colombia. The next generation of Colombian leaders will learn from the mistakes of their predecessors and will offer the people of Colombia real opportunities to improve their material and moral well-being.

References


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