

RESEARCH BRIEF

SHIFTING GEARS: A GROWTH DIAGNOSTIC OF PANAMA

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Background

In the past decade, Panama has been **one of the fastest growing economies** in the world, having managed to double its income per capita. Growth has been spearheaded by the development of a modern service sector on the activities surrounding the Canal, and non-residential construction. Large public infrastructure projects, and the private provision for infrastructure demanded by the service sector have fueled growth and created many job opportunities for low-skilled workers. Meanwhile, the service sector demanded high-skilled workers, which, due to the short supply of local high-skill labor, were often immigrants.

However, within this spectacular economic performance, there are two warning signs: first, Panama should prepare itself for a **deceleration of growth in construction**, as it is impossible that it keeps growing at a faster rate than the rest of the economy. Indeed, early indicators already point out to a significant **income deceleration**. Second, a diminishing construction sector threatens low-skilled jobs and may further increase **inequality**. This, in turn, could lead to social unrest and reduce institutional stability.

With those premises in mind, CID launched a research initiative aimed at exploring export diversification opportunities and understanding the potential binding constraints that Panama can run into in the process of shifting gears towards a sustainable economic growth.

Research Insights

- **Human Capital:** Given that Panama has followed a growth model based on sophisticated tradable services that demand highly specialized talent, **lack of know-how and skills in the Panamanian workforce is a major constraint to future growth**. The educational system does not seem to be ready to provide the technical skills the service sector demands. Panama's youth has been among the worst performers worldwide on international comparable competence tests, ranking last in mathematics in the 2009 PISA test. Though efforts have been made to improve this—average years of schooling has increased almost two years in a decade—much remains to be done in terms of quality.
- **Attraction and Retention of Foreign Talent:** Immigration has supplied the skills demanded by the thriving service sector and as such has been essential to the long growth spell experienced by Panama. As a result, immigrants' wages are higher than locals' across all sectors of the economy, and within the logistics, transport and communication sectors tally an impressive premium of 70%. That is a clear indication of talent scarcity driving wage premiums for foreigners up.

In order to maintain growth and decrease wage premiums Panama needs to revise its immigration policies and target professionals with the skill set and talents demanded by the service sector.

- **Knowledge spillovers:** Though Panama has been successful in attracting high-skilled immigrants over the past decade, it still has highly restrictive immigration laws. **Given that the country is currently lagging behind in terms of its workforce's know-how and skills, it is essential to revisit restrictions** such as the 10% cap to foreigners on payroll, the jobs restricted only to Panamanians, the prohibition for dependents of expatriates to work, and provide a path to residence to expatriate workers. Evidence shows that human capital diffusion is essential to growth and the extension of productive capabilities.
- **Institutions:** Panama's labor regulation has a mixed performance relative to other countries in the region. Red tape, though not a major issue, has room for improvement, as firms estimate that senior management spends a third of their time dealing with government requirements. **Corruption and the court system are the issues selected by most firms as major constraints.**
- **Infrastructure:** Endowed with the Canal, it is not surprising that Panama ranks very high in terms of trade-related infrastructures and logistics. Nevertheless, if the country diversifies its economy into more complex, energy-intensive sectors (for instance, manufacturing), there is evidence that it may run into a binding electricity constraint in some provinces. Also, Panama performs poorly in terms of broadband and Internet access, which could hamper further progress within a highly technological services sector.

Main Takeaways

Leveraging on the Canal, Panama has developed a major comparative advantage in the exportable services sector. In turn, the stellar growth in this sector has spurred the demand for construction, which has been key to promote upward social mobility and increase labor productivity. But there are signs that this sector is receding, incapable of sustaining growth rates that are higher than the rest of the economy. This threatens to undo some of the progress made in terms of reducing income inequality and poverty in the country, and have the potential to stir social unrest. To face these new challenges, Panama must increase its stock of human capital by improving the quality of education, which is among the lowest in the world. **Meanwhile, the country must open up to high-skilled immigration by removing harmful restrictions. To fully profit from immigration, it is equally important to maximize the diffusion of these skills and promote know-how spill overs through adequate policy.** Finally, Panama must strengthen its institutions and reduce red tape and corruption, which most firms currently consider the most binding constraint to growth.

Download the paper

https://growthlab.cid.harvard.edu/files/growthlab/files/panama_growth_diagnostics_wp_325.pdf

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