How to Revive Central America

A new report suggests reducing barriers to entrepreneurship.

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The "Northern Triangle" of Central America—Honduras, Guatemala and El Salvador—is one of the world's most dangerous regions. Drug trafficking and a weak rule of law have spawned powerful organized-crime networks that have overwhelmed government institutions. The instability has cost the region economically, feeding a vicious circle of poverty and violence with spillover effects for Mexico and the U.S.

The Trump administration recognizes that faster economic growth is part of what's needed for the region and is looking beyond simply throwing money at the problem. To succeed, it will have to break with the State Department's conventional wisdom that underdevelopment is caused by a paucity of taxes and regulation. It will also have to climb down from its view that trade is a zero-sum game.

Policy makers might start by reading a new report on micro, small and medium-sized businesses in Guatemala by the Kirzner Center for Entrepreneurship at Francisco Marroquin University in Guatemala City. It measures—by way of household surveys in 179 municipalities and interviews with industry experts—"attitudes, activities and aspirations of the entrepreneur." The work is part of the Global Entrepreneurship Monitor study for 2016-17, which covers 65 countries.

At a June meeting in Miami with officials from the three Northern Triangle countries and Mexico, Secretary of State Rex Tillerson spoke of the need to "improve the overall economic competitiveness" of the region and "boost the willingness of private companies to invest in Central America."

That had to be music to the ears of most Guatemalans since the GEM study ranks Guatemala No. 1 for its positive view of entrepreneurship as a career choice. Guatemala also ranks high (No. 9) for the percentage of the population engaged in new businesses, defined as less than 3½ years old. And it ranks 12th in terms of the percentage of the population who "are latent entrepreneurs and who intend to start a business within three years." Guatemalan early-stage entrepreneurs see themselves as innovative, ranking seventh in the perception that they offer a product that has a unique, competitive edge.

Yet Guatemalan eagerness to run a business has not translated into prosperity for the nation, and therein lies the lesson for Mr. Tillerson and friends. The country ranks a lowly 59th in entrepreneurs' expectations that they will create six or more jobs in five years. It also sinks to near the bottom of the pack (62nd) in creating business-service companies. More than 76% of businesses are consumption-oriented. Service businesses make up only 3.4% of all companies.

Failure to create jobs and grow, and the heavy concentration of businesses in the consumer sector, reflects the difficulty Guatemalan entrepreneurs have in getting credit. That's not unusual in an economy in which more than 72% of businesses operate underground and therefore cannot access the formal banking system. Those businesses generate income but they are not able to make investments for future growth.

The World Bank's 2017 "Doing Business" survey provides many clues about why the informal economy is so large. Guatemala ranks 88th out of 190 countries world-wide for ease of running an enterprise, but in key categories that make up the index it performs much worse.

The survey finds that it takes 256 hours to comply with the tax code. The total tax take is 35.2% of profits. It takes almost 20 days to start a legal enterprise and costs 24% of per capita income. To enforce a contract it takes more than 1,400 days and costs more than 26% of the claim.

Guatemalan migrants who make it to the U.S. are famously entrepreneurial and send home more in remittances every year than the total value of apparel, sugar and coffee exports. But at home the state is hostile to business and disrespectful of property rights. As a result, most new ventures see the cost of formality as outweighing the benefits.

The obvious solution is an overhaul of the tax, regulatory and legal systems in order to increase economic freedom. A lower tax rate and a simpler code would give companies an incentive to operate legally, thereby broadening the base and improving access to credit.

Instead the Guatemalan authorities—encouraged by the State Department and the International Monetary Fund—spend their resources trying to impose a complex, costly system in an economy of mostly informal businesses with a much-smaller number of legal, productive entrepreneurs. Recently the United Nations International Commission against Impunity in Guatemala recommended a new tax to fight "impunity."

This is no way to attract capital or raise revenue. Nor is Trump protectionism going to help Mr. Tillerson turn Central America around. Companies won't want to manufacture in the region if they don't have access to the U.S. market.

If the U.S. wants to see an economic recovery in the Northern Triangle, it has to recognize the reality of the market.

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