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DIRECTIONS IN DEVELOPMENT

# Unshackling the Private Sector

## A Latin American Story

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# Contents

## Text Tables



## Text Figures

# Foreword

During the past decade, many countries in Latin America and the Caribbean that previously were plagued by high inflation, a large debt burden, and low growth have transformed themselves into stable, capital-receiving, and growing economies. They achieved this by implementing high-quality policies that not only brought economic stability but also allowed the private sector to begin to be the principal source of growth. In effect, the private sector in the region has been unshackled, and it is this process that is outlined here.

This study examines evidence from a number of recent reports of the private sector in Latin America and the Caribbean and finds that the economic transformation that has taken place is not a simple story but the product of complex interactions among macroeconomic stabilization, incentive reforms, and institutional adaptation. No one element would have produced the results that have been achieved. For example, fiscal stability and better incentive structures give the correct signals for a shift of resources to more productive uses, but they do not address the barriers that hinder resource movement. Likewise, the traditional package of adjustment measures may be necessary to lay the foundation for rapid growth, but it is not sufficient to elicit a strong response from the private sector. Moreover, if the benefits of adjustment are perceived to be inadequate, public pressure mounts for reversal of both fiscally responsible policies and improved incentive structures.

There is a "second generation" of issues that strongly influence development of the private sector. Among these are the need to reduce the amount of discretion in policy regimes; the burden of regulation on businesses; the need for incentive reforms in new areas such as competition policy; the inability of the financial system to secure collateral; the cost of uncertainty of contracts under current legal systems; and issues related to the security of property rights. Specifically, a number of factors raise the risk and cost of business transactions and weaken the response to new incentives and macroeconomic reform.

In addition to reviewing a number of recent studies of the private sector in Latin America, this study also reports on the results of interviews with officials of a large number of firms in five countries. It was written with the objective of making lessons from the work being done in the World Bank available to a wider audience, including policymakers, academics, journalists, and all who are interested in developing countries in general and in Latin America and the Caribbean in particular.

*Shahid Javed Burki*
*Vice President*
*Latin America and the Caribbean Region*
*The World Bank*

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# 1
# Introduction

This study is a synthesis of the findings of a number of recent reports on the private sector in Latin America. It identifies which factors are crucial to establishing an economic and institutional environment that promotes private sector business activity. There is a growing realization that relative price incentives, institutional development, the functions of the state, and the working of goods and factor markets are interlinked in complex ways that affect how the private sector performs. Events preceding the widespread economic reforms during the past decade illustrated that statist policies are eventually immiserating—the private sector, not the state, is the engine of economic growth. But private sector confidence can be much more easily destroyed than built. What follows is a discussion of the factors that influence private sector business activity, whether positively or negatively.

The wave of economic and political reform that spread across Latin America over the past few years was the policy response to the debt crisis that began in the early 1980s (for a discussion of the background and consequences of the debt crisis, see Edwards 1993). These events forced a reevaluation of the role of the state in Latin America's economic life. Previously, state involvement in a wide range of economic activity was pervasive across the region. The public sector was involved—either directly through ownership or indirectly through extensive regulation—in numerous economic activities that would have been better performed by the private sector. At the same time, governments were failing to perform such essential functions as stabilizing prices, ensuring security and law enforcement, operating effective dispute-resolution mechanisms, or providing inexpensive and good-quality educational systems and functional and reliable infrastructure. Furthermore, it became apparent that the promise that state intervention could ensure prosperity and rising living standards was an empty one. Instead, the widespread introduction of import substitution policies and statist control had the opposite effect: inefficiencies mushroomed, growth rates languished, and income distribution worsened. There was a growing realization that only the private sector could generate the economic growth

that would reduce poverty over the long term.

When external financing dried up after the debt crisis, governments could no longer support economic policies of dubious worth, and many were forced into radical adjustment programs. Over little more than ten years, many countries abandoned the statist, import substitution regimes of the earlier period, undertook macroeconomic reform, and adopted outward-looking market-oriented policies. Virtually every country in the region went through some type of reform episode, although there were wide disparities in the extent and depth of the so-called "first generation" of reforms (macroeconomic policy, trade reform, financial reform, and privatization). In some countries, such as Argentina, Bolivia, Chile, Mexico, and Peru, this phase of the adjustment was extensive. In others, such as the Dominican Republic and Venezuela, there remains much to do.

One of the most important elements of the reform effort in many countries was the sale of state-owned enterprises. This helped shift the emphasis to the private sector as an engine of growth and focused interest on the factors that promote or hinder private business activity. The hope was that reform would engender greater efficiency and investment, which in turn would lead to higher growth. Many of the policy changes required great political courage, not only to deal effectively with powerful unions of government employees and with entrenched political interests, but also to push through market-oriented reforms that eliminated the substantial monopoly rents earned by sheltered industries.

Eliminating this type of government protection exposed the private sector to the harsh winds of international competition. In some countries, particularly those where reform occurred early, growth rates have been high and have even approached those achieved in the Asian "miracle" economies; in others, the response has been disappointing. The varied result of reforms across Latin America has led to the growing realization that although macroeconomic reform is necessary to promote sustainable growth, other policy measures—the "second generation" of reforms—may be necessary to ensure that resources shift rapidly from inefficient activities into those with the potential for long-term growth. Clearly, there are other factors that promote private sector development and that need to be better understood. Furthermore, many countries had gone through several earlier reform episodes, most of which had been reversed, either partially or fully—a fact that was not lost on potential investors. The existence of a "credible commitment" to the reforms on the part of the government has assumed great importance. The possibility that reform will be reversed continues to be a concern, and in Venezuela it has become a reality.

The World Bank and the International Finance Corporation (IFC) have responded to the uneven results from the reforms by devoting significant resources to the evaluation of how the private sector operates in Latin America. They commissioned private sector assessments—studies of the

environment for doing business for many countries in the region. Eight full country studies have been completed, and several more are under way or planned. In addition, a conference jointly sponsored by the Pontificia Universidad Catolica de Chile and the World Bank was held in October 1994 in Marbella, Chile, to discuss the issues arising from these studies. A number of common themes have emerged which support the emphasis that the international financial institutions have placed on macroeconomic stability and trade reform and point to several important areas that have been overlooked to some extent in the past. The purpose of this work is to summarize the results to date regarding the most important factors that influence private sector activity.

These factors are often studied—and acted upon—in isolation. Macroeconomic policy, trade reform, privatization, the legal system, infrastructure, regulation, financial markets, labor markets, and tax policy are linked, and these linkages need to be analyzed if the full impact on the private sector of changes in these factors is to be understood. For example, the important role of institutions has only recently been identified and so far remains undocumented. Institutions determine the transaction costs underlying production, exchange, and interactions in the marketplace. As an economy develops and changes, the nature of the institutional structure must evolve to accommodate the more complex and specialized nature of transactions. Where formal institutions are weak, high transaction costs undermine the ability of the private sector to engage in increasingly specialized activities.

More highly evolved institutions allow for a greater division of labor and specialization, two processes that promote higher productivity and reduce the costs of doing business and therefore underlie economic growth. As specialization increases, the minimum scale of production rises, which demands more widespread markets and increasingly complex and impersonal transactions. To attenuate the risks of such impersonality, property rights need to be clearly delineated, and a framework for enforcing contracts needs to be developed. Institutions are needed that permit more effective management of risks.

In the absence of formal institutions, the private sector has developed its own methods of containing risk, including resorting to informal arrangements; avoiding complex, impersonal, or long-term contracts; and hiring facilitators to deal with the inefficiencies of existing institutions. All these activities raise transaction costs and inhibit private sector development. Although many aspects of the reform in the region have been extensively researched, it has usually been from the perspective of the overall macroeconomic and trade reform, and the specific effects on the private sector have been ignored. This study aims to fill the gap. It takes a private sector perspective of the postreform conditions, examining the effects on business in the region of macroeconomic and trade reform, the contracting

environment, the security of property rights, the regulatory system and the financial sector.

Chapter two analyzes the business environment in several Latin American countries using the results of surveys of the private sector in eight countries; Bolivia, Brazil, Chile, Columbia, Ecuador, Mexico, Peru, and Uruguay. The ease of business-to-government and business-to-business transactions is discussed, as well as private sector perceptions of factors that slow business expansion. The phenomenon of informality, which is pervasive in the region, is described and discussed. A number of the issues raised in chapter two are taken up in greater detail in subsequent chapters.

In all the surveys, respondents stressed the importance of the macroeconomic environment. Most respondents also perceived macroeconomic stability as being closely related to political stability. These issues are addressed in chapter three.

Chapter four covers the relationship between trade policy and private sector development. The business community often complains vociferously about competition from imports, particularly in economies that have followed policies of import substitution. However, the importance of liberal trade policies in promoting private sector development is proved by the success of export sectors in those economies that have liberalized, as well as by the dynamic efficiency improvements prompted by opening economies to competition from imports.

Chapter five covers the effects of regulation on private sector development, particularly the costs and benefits of regulation. It finds that there is insufficient "good" regulation of newly privatized companies and a plethora of "bad" regulation, in the form of systematic interference in the ability of the business community to establish and operate firms. In many countries in the region, where privatization is proceeding rapidly, social goals require that a regulatory framework be established to oversee those newly privatized companies that are not subject to internal or external competition. However, the institutional structure and technical capabilities in many of the countries are insufficient for complex regulation, and any regulatory systems should reflect the institutional and technical capabilities in place. In some Latin American countries, regulation has had a damaging impact on private sector development. Many countries have implemented complicated and often contradictory rules governing business behavior—with the result that they are either ignored, which engenders disrespect for the law in general, or rigorously enforced, with a stifling effect on business activity. In addition, intervention in the labor market has been widespread across the region, in the form of regulation, restrictions on companies' labor policies, and complicated taxes and levies. Evidence shows that such policies have had a damaging impact on productivity and employment creation.

Chapter six discusses the relationship between private sector de-

velopment and the financial sector. Much of the business community, in the industrial and the developing world alike, complains about access to finance. However, in many Latin American countries the financial sector is inadequately developed and does a poor job of intermediating funds between savers and investors.

In many countries in the region, the sale of state-owned enterprises has resulted in impressive increases in efficiency and investment. Chapter seven explores the experience of privatization and the lessons learned about the successful sale of such companies, as well as the regulatory implications of privatizing.

Public institutions, especially the legal system, play a vital role in the ability of the private sector to enter into contracts with confidence. Chapter eight discusses the role and importance of such public institutions and property rights in fostering economic development. In many Latin American countries, the legal system is inadequate either because of contradictory laws or because enforcement mechanisms do not work. Property rights also are poorly defined. Land titling and registration is difficult and expensive, and large sections of the population possess only occupational title to their land and dwellings. Therefore it is almost impossible to use moveable property as collateral and funding business growth using either personal or business assets is difficult. In some cases private institutions have taken the place of public ones, but where political instability has prevented this from occurring, transactions and contracts occur only between people who know each other. This creates an insider-outsider business environment that perpetuates particular patterns of income distribution and makes it more difficult to establish new businesses.

The final chapter in this study summarizes the lessons learned to date and points to areas where more work remains to be done to understand the complex and interrelated effects of macroeconomic conditions, incentive policies, and the institutional setting, and to formulate better policy prescriptions.

# 2
# The Latin American Business Environment

Although conditions vary widely across Latin America, it is possible to generalize about the essence of the problems facing businesses in the region. The reforms of the 1980s and early 1990s will doubtless increase productivity and competitiveness in many Latin American countries over time (Edwards 1993). Nevertheless, detailed studies of Latin America's private sector and, in particular, those assessments done by the World Bank, reveal that a substantial portion of the region's business community sees many obstacles that hinder their efforts to modernize and become more efficient.

Whether the business environment encourages or discourages the formation and success of businesses depends on the cost of doing business, frequently referred to by economists as transaction costs. These determine how businesses are organized, the terms and nature of their contracts with employees, and how they interact with other companies and with government. This chapter examines a number of conditions that determine transaction costs, including how businesses are started and closed (barriers to entry and exit); business-to-government and business-to-business contracting; obstacles to and incentives for the growth of enterprises; and finally, incentives and disincentives to informality, one of the most pervasive phenomena in the region.

The institutional framework for doing business is set by rules and enforcement mechanisms governing business behavior. The rules are both formal, the most important being the legal system, and informal—the private rules set by parties to a transaction. The business environment is also affected by institutions that govern more general behavior, such as law enforcement and the judicial system. Because economic growth is associated with the increased division of labor, more complex and impersonal transactions, and longer-term contracting and investment horizons, the environment for business improves as the institutional framework gives greater support to this evolution. Weak institutions distort the pattern of business

transactions and organization, raise risk, and discourage development.

Macroeconomic and relative price reforms have occurred in many Latin American countries bringing some corrections of relative price distortions and improvements in the macroeconomic climate. Nevertheless, the slow response to these reforms indicates that substantial barriers to resource transfer remain. These barriers are linked to weak institutions, and the process of institutional reform is only beginning in many countries. Furthermore, the process is neither well understood nor rapid. The role of the state in designing and implementing reform and in improving the business environment may be crucial to the success of this process.

Over the past decade perceptions regarding the role of the state have changed. Previously, under the prevailing paradigm in Latin America, the state had a central role not only in the provision of public goods such as security and law enforcement, but also as an owner of "strategic" resources and as the architect of private resource allocation, using a system of laws, subsidies, and taxes. In practice, this role manifested itself in import substitution policies and preferential benefits to some sectors and firms. This system encouraged rent-seeking behavior, whereby profits depended not on innovation and ability to compete, but rather on access to monopoly rents. The resulting inefficiencies severely hampered the capacity of most economies to adjust, which became painfully apparent with the debt crisis. Reforms have recently begun to change the role of the state through divestiture and privatization of assets, as well as through deregulation. However, in many countries, entrenched industrial groups and from civil servants have been reluctant to relinquish the power they enjoyed under the prevailing lack of transparency and haphazard enforcement.

**Table 2.1 The Costs of Establishing a Garment Business in Selected Countries**

| *Country* | *Total direct cost (in dollars)* | *Total time (in months)* |
|---|---|---|
| Brazil | 640 | 1.6 |
| Chile | 739 | 2.0 |
| Peru[a] | 194 | 9.6 |
| Peru[b] | 800 | 4.4 |

a/ Hernando de Soto estimates
b/ World Bank estimates
*Sources*: Unpublished country data and *The Other Path*, H. de Soto 1989.

**Box 2.1 A Barrier to Entry: The Taxicab Market in Uruguay**

In a case study familiar to a generation of economics students in U.S. universities, Milton Friedman described the regulation of the market for taxicab medallions in New York City. The situation in Montevideo is much worse. In 1990, the market price of a taxicab medallion in Montevideo was about $60,000, compared to $125,000 in New York. Given the lower per capita income in Uruguay, the market value of a license was more than four times higher in Montevideo. Regulation of the taxicab market has led to a scarcity of taxicabs, reflected in the difficulty of hailing taxis in the downtown area, long waits for taxis requested by telephone, high costs to consumers, and wasteful rent-seeking activity on the part of the taxi owners.

## Barriers to Entry and Exit

Hernando de Soto (de Soto 1989) documented the procedures necessary for establishing a business in Peru. He found that the process involved over a thousand different steps, 289 days, and cost (including for-gone profits) more than $1,000. Of course, this is a stylized example; in most countries lawyers or "fixers" can be hired to navigate the process much more rapidly. The *despachantes* in Brazil and the *tramitadores* in Peru are typical of the type of fixer who operates in most Latin American countries: they are specialists in overcoming bureaucratic obstacles through their frequent dealings with public sector employees. "Fixers" fees range from $600 to $800 to establish a company in most Latin American countries, substantially more as a percentage of per capita income than in most industrial countries, (see table 2.1). Furthermore, these fees rise quite sharply as the size of the firm goes up.

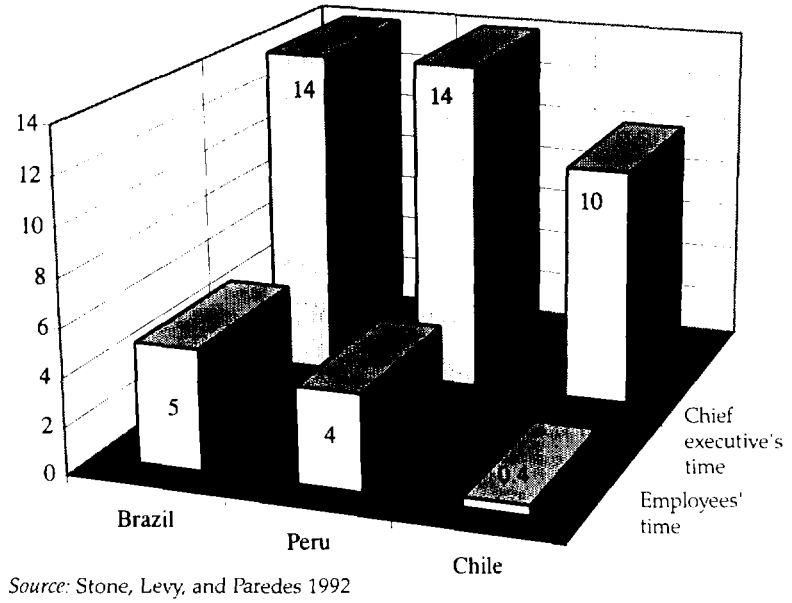
Interviews with entrepreneurs in the informal sector in Brazil, Ecuador, Peru, and Uruguay, identified the high cost of formalizing their businesses as one of the most important factors in their decision to stay outside the formal sector. In particular, they cited costly licensing and paperwork

**Box 2.2 Exit Constraints in Uruguay**

There are 187 slaughterhouses and 45 packing plants in Uruguay. Of the 39 packing plants that handle beef, 30 are licensed to prepare beef for export; only 14 of these are licensed by the U.S. Department of Agriculture and only 12 by the European Union. Excess processing capacity in the export group alone is estimated at 82 percent. Volume and profits are already down at packing houses, and Uruguayan producers are rebuilding their herds and sending fewer cattle to slaughter. In a well-functioning market, there would be a significant shakeout, yet only 13 plants have closed in the past three years. This indicates the exit constraints that firms face, particularly those in debt to the Bank of the Republic of Uruguay.

requirements at the municipal level. Such entry barriers, which discriminate against start-up ventures, explain why relatively few small companies in Latin America are formally registered. Yet businesses engaged in informal economic activity, which is widespread in the region, have only limited access to

Figure 2.1 Cost of Compliance with Government Regulations in the Garment Industry in Selected Countries, 1993 (percentage of total work time)




*Source:* Stone, Levy, and Paredes 1992

capital markets and the legal system.

Exit barriers—restrictions on firms' ability to downsize or to go out of business altogether—are another obstacle to commercial enterprise. When potential investors are uncertain whether they can scale back their operations during bad times, their risk is increased, often discouraging them from investing at all. Exit barriers were ubiquitous in Latin America in the prereform period, but were either eliminated or reduced in many countries in the region as part of reforms.

## Costs of Dealing with Government

Once firms enter the formal sector, they spend a significant amount of time dealing with government at all levels, despite the weak enforcement of antitrust and anti-competitive regulations and lax tax collections. In five of the studies of the private sector in the region two measurements were used to assess the cost of dealing with government: the amount spent on external

accountants to handle tax problems, and the time spent by entrepreneurs and employees in dealing with government (figure 2.1). As the impact of regulation on business performance has been shown to be significant in all five countries studied, this is likely to be a significant problem throughout Latin America.

The results suggest that Chile's regulatory system is more efficient than that of Brazil or Uruguay. Chilean firms devote fewer management and employee resources to regulation-related activities. Uruguay has a relatively complex tax system, as shown by the high use of external accountants, and Brazil has a more discretionary set of rules, which presumably is the most time-consuming activity for entrepreneurs. For example, in the machine tool industry in Brazil, over one-quarter of entrepreneurs' time was spent in dealing with government rather than in running their businesses—an astonishingly wasteful use of managerial resources.

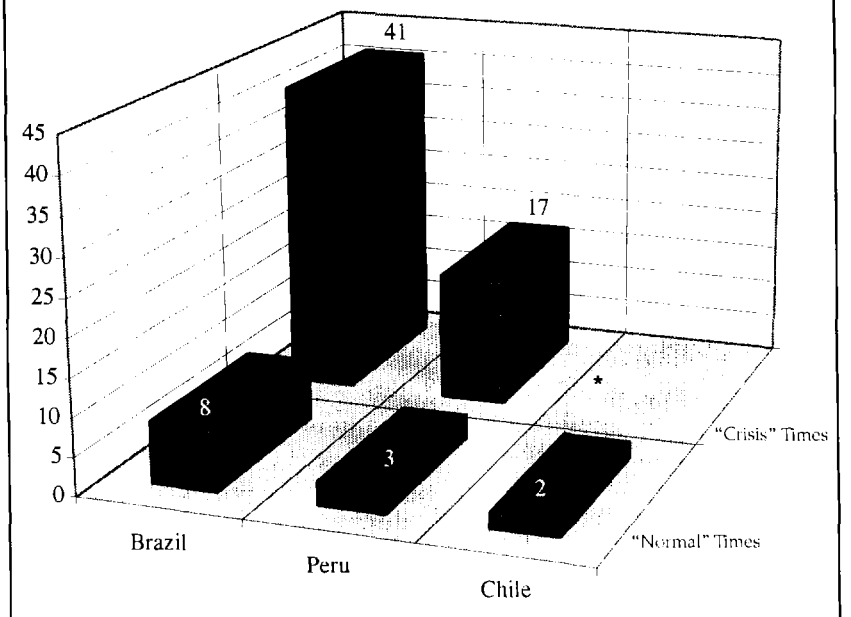
## Government Influence on Business Relations

Besides the direct effect of government regulation and taxation on business, governments influence and affect the performance of businesses in another important way—through the legal and judicial systems, which determine how conflicts are settled and how property rights are enforced. If these mechanisms are efficient, firms can expect to face low transaction costs. If they are inefficient, firms will try to find ways to avoid them. But finding substitutes for formal legal and judicial processes is also inefficient and expensive.

The evidence from the private sector surveys supports the idea that where it is more difficult to settle conflicts, business-to-business relationships are more complex. Even in Mexico, where the government has made substantial efforts to improve the legal environment in order to facilitate private commercial activity, lack of faith among the business community in the judicial system as a fair and efficient mechanism for resolving disputes is widespread. The situation is much worse in many other countries in the region. In Peru, for example, the court system is perceived to be inefficient and unresponsive to the needs of business for dispute settlement: it takes years for even minor cases to be settled and the outcomes are highly uncertain; court officials are considered corrupt and bribery is common. Businesses rarely use the courts to enforce contracts, which encourages the formation of vertically integrated firms and forces smaller firms to limit their transactions to a small circle of associates.

This situation is common in many countries in the region: in the absence of functioning dispute-resolution mechanisms, business transactions take place on a personal basis and knowledge of the other person becomes much more important. The result is an "insider–outsider environment," which reduces efficiency and perpetuates particular patterns of (usu-

Figure 2.2 Share of Sales Contracts Renegotiated in the Garment Industry, 1991




*Source:* Stone, Levy, and Paredes 1992 * Not applicable

ally unequal) income distribution.

What kind of substitutes, if any, have evolved to replace the inefficient formal legal system in the countries where it does not work? Although Brazil has a slow, inefficient judicial system and high macroeconomic uncertainty, there is a wide range of private institutions that record and disseminate information about customers, as well as a reasonably efficient way of processing delinquent commercial defaulters. The result is that in both Brazil and Chile, where the legal system works relatively well, firms commonly grant credit to new customers (about 90 percent of firms do so). By contrast, evidence from the surveys of the garment industry in Peru shows that private alternatives for collecting debts are virtually nonexistent and trade credit hardly exists (most transactions are on a cash basis), which reduces the number of business transactions. Why informal institutions have not developed in Peru is difficult to explain. A possible cause is the country's long history of institutional instability and of public policies that were at times openly hostile to business activity.

A comparison of garment industries in Brazil and Chile yields interesting evidence regarding differences in informal contracting. Orders for garments do not have legal status in either country. In Brazil the terms

**Table 2.2 Principal Obstacles to Business Growth in Latin America**

| Obstacle | Average |
|---|---|
| Political or policy uncertainty | 0.73 |
| Inflation | 0.69 |
| High taxes | 0.65 |
| Financing | 0.52 |
| Tax bureaucracy | 0.50 |
| Labor regulation | 0.50 |
| Informal competition | 0.47 |
| Other forms of bureaucracy | 0.46 |
| Lack of competent workers | 0.45 |
| Procurement and sales | 0.37 |
| Access to equipment | 0.31 |
| Infrastructure | 0.27 |

*Note:* The scale runs from 0 (no constraint or barriers to growth) to 1 (maximum difficulty).
*Source:* Stone, Levy, and Paredes 1992.

of purchase orders are not considered binding, since prices and conditions are often renegotiated until the time of delivery (figure 2.2). Conversely, in Chile purchase orders are rarely renegotiated. This suggests either that Chile has better alternatives for settling disputes or that the macroeconomic uncertainty in Brazil prompts opportunistic behavior and makes reliable contracting difficult or impossible. The evidence indicates the latter. Although there are relatively low-cost institutional substitutes for Brazil's slow and inefficient judicial system, in Chile with its formal and informal mechanisms, fewer people pay late, and relatively few are taken to court to redress the problem.

Government thus affects transactions between businesses directly and indirectly. If governments do not provide adequate public goods, particularly a reliable legal framework for contracting and effective mechanisms for resolving disputes, they distort the way firms structure their transactions. When government policies foster macroeconomic instability, the overall contracting environment is degraded, resulting in opportunistic behavior, lost transactions, and greater risk—all of which reduce efficiency.

## Obstacles to Business Growth

The private sector surveys indicate that the main obstacles to business growth include a generally unstable macroeconomic environment featuring inflation and price instability, political and policy uncertainty, legal and regulatory issues, and other economic and institutional problems. The most important obstacles identified in the surveys of several hundred firms in four countries are listed in decreasing order in table 2.2. The results should be interpreted with great caution since cross-country comparisons of survey data are fraught with methodological difficulties; nevertheless, they give an

**Box 2.3 Poor Infrastructure in Colombia**

Flower exporters in Colombia face a major obstacle that their competitors in the U.S. and elsewhere do not have to deal with—lack of reliable phone services. Since flowers perish rapidly after cutting, instant access to market information is crucial. But Colombia's flower producers, located mostly in the savanna of Bogotá and around Medellín for the sake of proximity to airports, have no reliable telephone service to their farms. In the past, they overcame the problem by renting offices in Bogotá to be in direct contact with their overseas buyers, a costly arrangement in terms of manpower and rent. The Colombian Association of Flower Growers now plans to install a private network linking the headquarters with growers' farms. Even at approximately $2,000 per line, that will cost much less than maintaining an office in Bogotá.

idea of the ranking of concerns.

There are three main kinds of obstacles to business growth. *Macroeconomic and political uncertainty* raises doubts about the course of future policy. That in turn increases the risk of investment or, in the case of high inflation, increases uncertainty by distorting relative price signals. *An uncertain and unstable regulatory framework* has a negative effect on growth by raising the degree of uncertainty and therefore the rate of discount for new investment. Finally, more subtle factors, defined here as *institutional*, adversely affect the business environment. These factors involve a "lack of complementarity" between government behavior and business activity. Governments can support the operations of the private sector in many ways: providing a well-functioning court system and adequate infrastructure are two examples. The first two groups of obstacles referred to above are associated with excessive government intervention in the economy; institutional factors, by contrast, involve either a lack of support for business by the government, or government failure.

Entrepreneurs clearly attach high importance to the stability of the macroeconomic and political environment. In all the countries surveyed, this factor tops the list of concerns. The first step in removing the obstacles to business development in Latin America therefore should be to empha-

**Box 2.4 Municipal Regulation in Peru**

In Peru, regulations and how they are applied still add to the cost of doing business for many companies. For example, companies in one municipality are required by law to fumigate their factories once a year. The municipality has licensed a single firm as the official fumigator. Its prices are double those of other fumigation companies and its service very poor, yet only that company can issue a certificate of compliance with the regulations.

size macroeconomic and political stability, for three reasons. First, political and economic instability have been endemic in most of Latin America for several decades. The desire for greater macroeconomic and political stability on the part of the private sector reflects the need to compete with more efficient foreign producers, now that reform has exposed many firms to the rigors of international trade for the first time. Second, reducing inflation and creating macroeconomic stability may be accomplished over a relatively short period. Third, stability creates very significant "spillovers" that may reduce the effect of other obstacles to business growth—a relationship apparent in the survey.

For example, there was an important change in entrepreneurs' attitudes in Peru after President Alberto Fujimori instituted strong reforms in 1990. Before the reforms, inflation, political and policy uncertainty and security were the three most important issues. In 1993, after the reforms, the situation changed sharply: high taxes became the most important issue, followed by political and policy uncertainty, the perception of unfair competition, and security. Inflation ranked only fifth. Moreover, almost all other macroeconomic and political obstacles ranked higher in 1990 than in 1993, the only exception being the level of taxation. Although some structural changes may have been achieved, most of the shift registered in the 1993 survey was a change in *perceptions* about the macro-political environment.

Financing is one area that entrepreneurs identified as appropriate for greater government involvement. The surveys suggest that entrepreneurs throughout the region perceive financing to be among their most pressing problems. However, care must be taken in deriving policy implications from this result: entrepreneurs associate financial obstacles with several different factors, especially high interest rates, which may be a short-run effect of policies introduced to promote macroeconomic stability or a reflection of the risks associated with a poorly functioning legal system. In particular, the collateralization of assets, especially moveable assets, that supports credit systems in most developed countries is not possible in most countries in the region because of both weak property rights (even fixed property is frequently poorly defined and titles are insecure) and deficiencies in the collateral system itself (the mechanism for repossessing assets is

**Box 2.5 Labor Inflexibility in Peru**

Firms in Peru have been unable to retire anyone, even when they reach retirement age. Although retirement is clearly defined in principle, in practice ambiguities in the law allow someone who was retired to sue for unfair dismissal. While the case is pending in the courts, companies are forced to pay the worker's wages. One supermarket chain claimed it closed down a food-processing plant because of inadequate demand for its output, but was forced to continue paying its workers for a year even though they had nothing to do.

weak in most countries). As a result, lenders insist on overcollateralization, allow only real estate to be used as collateral, charge high interest rates to reflect systemic risks, or deal only with people they know well.

The second kind of obstacle to efficiency and growth is an uncertain and unstable regulatory framework, particularly unfair competition. In particular, entrepreneurs complained of unfair competition from firms that do not comply with tax and labor regulations. Much of this unfair competition is seen to come from informal firms. However, since tax rates are high in many countries and labor regulations are onerous, even formal firms engage in illegal practices. For example, formal firms often sell part of their production through informal mechanisms.

Introducing reforms to stabilize the economy may generate immediate needs such as skilled workers and infrastructure. These fall into the third set of concerns outlined above, the lack of complementarity between government behavior and business activity. In some cases, these needs can be satisfied without significant further government involvement. Promoting infrastructure development through concessions, as in Mexico and Chile, can save an enormous amount of money and limit the involvement of the government. Still, an important role remains for the state: when government auctions the right to build and operate a road, a tunnel, or any infrastructure project, the conditions under which the private and the public sectors relate should involve as little uncertainty as possible. Confidence in the court system and expedient dispute resolution help to eliminate deficiencies in these areas and promote more efficient private sector activity. Furthermore, public sector infrastructure commonly complements some private sector investment, including investment in infrastructure, which involves important quasi-rents. Private investment is favored in a context where property rights are well defined and uncertainty is limited.

Although government intervention in goods markets has declined with reform, regulation of factor markets, particularly labor, continues to damage the business environment in many countries. Interference in the labor market takes three forms: first, obligations to employees for benefits, such as payment of vacation bonuses, housing bonuses, extended paid maternity benefits, and mandated employer insurance contributions; second, restrictions on the ability of employers to dismiss workers, requiring large severance payments for dismissal; and third, wages, particularly minimum wages, set by decree.

In Brazil, Ecuador, Jamaica, Uruguay, and Venezuela, the business community complains about the lack of flexibility and costs imposed by labor legislation and taxes. By contrast, a preliminary assessment of the recent reforms in Peru and Columbia indicates that they have had a positive effect on labor mobility and hiring practices. The effect of restrictive labor legislation was far less damaging under import substitution policies. Indeed, such legislation could be seen as a way of sharing between employers

and employees the monopoly rents that resulted from lack of competition. Once the economies are opened, however, the high labor costs associated with such regulation reduces firms' ability to respond to new opportunities arising from reform. This burden also falls disproportionately heavily on larger firms because of the relative ease of enforcement.

Further costs are imposed on employers by overly burdensome administrative requirements. In Brazil, for example, firms are required to pay ten different labor taxes and charges, with different bases for calculation, which are paid on different days for different periods. Employers react to the added costs of such interference in the labor markets in different ways. In Brazil the labor market is remarkably flexible because labor legislation is often observed in the breach. Companies simply ignore regulations, relying on payoffs and influence to circumvent requirements. In other countries, regulation encourages informality as well as discouraging investment and employment growth. In all cases, this imposes additional costs on business. Tokman (1992) estimates that regulations raise labor costs by 20 percent for small firms in Latin America.

## The Informal Sector

Most Latin American economies have large informal sectors. In 1989, the informal sector in urban areas employed on average about 31 percent of the labor force. In most countries in the region, 50 per cent or more of the labor force is engaged in informal activities, if the rural informal sector is included. Many income surveys indicate that those employed in the informal sector of the economy earn low wages and are frequently poor. The relationship between informality and poverty thereby has captured the attention of many researchers. Nevertheless, what causes informality and whether it constitutes a long-term problem is poorly understood.

Despite many attempts to define informality, a satisfactory all-encompassing definition remains elusive. Most definitions have little analytical content and many are tautological. Concepts and statistical measurement are often confused. For example, some involve deriving informality from GDP or other residuals; others rely on legalistic definitions. For our purposes, informality is defined as a behavioral response to a set of economic and institutional incentives that results in economic agents under-

**Box 2.6: Informal Power Suppliers in Peru**

Formal entrepreneurs in Peru often complain about the unreliability of the power supply. Yet many informal businesses are apparently able to obtain power and water illegally. Interviewers even discovered informal "middlemen" who were selling power to small informal companies at very low rates. Ironically, they all complained bitterly about the unreliability of power supplies.

taking certain types of economic activity and organizing in specifically identifiable ways outside the formal institutional framework. This is a very broad definition encompassing behavior that has many forms and gradations, but it must suffice. Criminal activity will be ignored here, and there will be only passing mention of tax evasion and other measures taken to avoid regulation by companies that are registered and that employ significant numbers of people, even though these are informal activities in terms of some definitions and measurements of informality.

*Characteristics of Informality*

Informal economic behavior takes many forms, but it commonly involves activities that bypass formal institutions—that set of rules and laws that governs economic behavior. Informal economic activity typically involves short-run activities; formal contracts are rare in work such as street trading, trading in informal markets, family business activity, handicraft manufacturing, and peasant farming.

Firms in the informal sector usually employ family members and are very small; most employ less than five people (see, for example, Carbonetto, Hoyle, and Tueros 1988). Coase (1937) pointed out that firms, the essential characteristic of which is hierarchical organization, exist because operating in a pure market environment involves significant transaction costs. The decision to operate as a firm, rather than operate directly in the market, rests on whether the benefits gained from reducing transaction costs through hierarchical organization outweigh the cost of reduced flexibility and the absence of continual price signals from the market. Transaction costs are usually higher in developing than in industrial countries. In part, this is because communications are less efficient and more expensive, infrastructure is weaker, and legal systems function less well. These factors tend to promote organization into hierarchical structures (firms) and limit actions through markets; yet most developing countries have far fewer firms per worker than do industrial countries. Since in any economy a certain equilibrium exists between activities performed by firms and those performed by individuals, the distortion of incentives to organize entails costs in terms of productivity losses.

Distortion of the natural share of the formal sector is costly. When, through subsidies or other artificial methods the cost of formal labor contracts is reduced, society incurs losses by foregoing the efficiency of markets. If, however, the use of organized labor in enterprises becomes artificially costly through heavy taxation, harmful regulations and misguided public interventions, as has been the case in Peru, the share of the informal sector increases, with equally important losses to society in terms of excessively high transaction costs.

*Causes of Informality*

Since informality is such a pervasive phenomenon, there must be incentives to be informal. Informality is often closely associated with tax evasion. When tax enforcement is weak, the potential savings realized from not paying taxes provides a strong incentive to informality. In addition, the implicit tax on formal firms that results from regulatory requirements adds another incentive to operate informally. Finally, engaging directly in market activities, avoids the need to pay labor taxes and surcharges, which have become a significant portion of the wage bill in many countries. In countries where the institutional structure is weak and where the provision of public goods is sporadic or nonexistent, the incentives to give up informal status are not strong. The legal system does not function well and is inadequate for enforcing contracts; property registries do not function well enough to allow assets to be pledged as security for bank loans; and law enforcement is sporadic at best and venal at worst. Impersonal exchange with third-party enforcement is the critical underpinning of successful modern economies. The higher the degree of specialization in an economy, the more institutions need to be reliable. The absence of a strong institutional structure therefore not only is a great drag on development but limits incentives to be formal.

Other barriers to formality arise from interference in financial and factor markets. For example, the widespread rationing of foreign exchange in many Latin America countries in the prereform period meant that large sectors of the population had access to imported capital equipment and inputs only at high prices. Such credit rationing leaves outsiders, particularly those in the informal sector, without any hope of gaining access to the financial markets. Many members of the informal sector therefore see even less benefit in becoming formal.

*Consequences of Informality*

An important question is whether the presence of large informal sectors is a stage through which developing economies must pass or whether it is a specific consequence of institutional failure, particularly government failure. In many Latin American countries, rapid migration to urban areas has resulted in more job seekers entering the urban labor force. Unable to find work immediately and lacking unemployment benefits, they are forced to engage in such activities as trading, simple handiwork, or crafts to support themselves and their families. If these are merely temporary activities while they search for more productive employment in the formal sector, then informality has a positive role to play in helping labor markets adjust. But, if these people merely sink into a permanent and desperate fight for survival

against the poverty associated with employment in the informal sector, the existence of informality represents a severe drag on development. At this point, there is little information on how long it takes to make the transition from informal activity to formal employment.

Organizing economic activity into nonhierarchical structures not only incurs higher transaction costs but also has two other effects. First, it severely limits the ability of those workers who have specialized skills to combine in a complementary manner with physical capital, and enhance productivity. The new literature on labor markets treats human capital as a complement to, not a substitute for, physical capital. Informal organizational structures do not allow this complementary relationship to form. The very nature of this form of organization biases production processes away from using physical capital, and the lack of access by informal businesses to financial markets means that any investment must be made from self-generated funds. Second, the lack of hierarchical structures diminishes the incentives and opportunities for on-the-job training and for investment in industry- and firm-specific human capital. The result is a lower value of human capital. Several studies have shown that returns to education in the informal sector are lower than in the formal sector (see Gindling 1991) and some indicate that investment in education has a zero return in the informal sector (see World Bank 1993a). A further implication of the low productivity in the informal sector is the effect on long-term growth and the distribution of income. Abstracting from cyclical changes, the long-term rate of economic growth depends on the rate of growth of productivity. If a significant portion of the economy is cut off from productivity improvements, there is obviously a negative impact on the growth rate. Productivity in the formal sector must grow that much faster in order to raise overall living standards. In addition, as productivity growth increases wages in the formal sector, the distribution of income worsens as the relative remuneration of members of the informal sector declines. If the hypothesis regarding the low potential for productivity improvements in the informal sector is valid, growth in developing countries will necessarily bring worsening income distribution.

What then are the policy implications for the informal sector? First, removing some of the negative incentives for informality will reduce the size of this sector. Reducing the cost of company formation, reforming the judicial system, reforming restrictive laws regarding hiring and dismissal of workers, and simplifying the tax system are examples of measures that are necessary in themselves and that will reduce the size of the informal sector. Second, policy measures should be aimed at encouraging informal firms to become formal rather than at trying to aid directly members of the informal sector. Therefore, improving the overall business environment is one of the most effective ways of encouraging formality.

## Lessons of Reform of the Business Environment

Some aspects of the environment for doing business in Latin America have improved as a result of the reforms. In nearly all countries in the region, inflation rates have come down, trade reform has occurred, and financial markets are operating more efficiently. In some countries such as Chile and more recently Peru, the extent of the reform has been truly remarkable. However, reforms that result in reductions in the costs of doing business—the second generation of reforms—have been much less spectacular or have not occurred at all, even in the countries where first generation reforms have been more radical. The result is that the business communities in most countries in the region still perceive substantial difficulties in doing business. These issues are discussed in more detail in the chapters that follow.

# 3
# Macroeconomic Policies

This chapter examines the impact of macroeconomic policies on private sector activity. As a result of reforms instituted over the past several years, the macroeconomic performance of most countries in the region has been good, even remarkable, compared with the grim picture of the early 1980s.

**Table 3.1 GDP Growth, Inflation, Current Account Deficit, and Fiscal Deficit in Selected Countries, 1980–93**

| *Indicator* (percent) | *Bolivia* | *Brazil* | *Chile* | *Colombia* | *Ecuador* | *Mexico* | *Peru* | *Uruguay* |
|---|---|---|---|---|---|---|---|---|
| *GDP growth* | | | | | | | | |
| High (>3.5) | | | x | x | | | | |
| Intermediate (2.5–3.5) | | | | | x | x | | |
| Low (<2.5) | x | x | | | | | x | x |
| *Inflation* | | | | | | | | |
| High (>75) | x | x | | | | | x | |
| Intermediate (50–75) | | | | | | x | | x |
| Low ( <50) | | | x | x | x | | | |
| *Current account deficit as share of GDP* | | | | | | | | |
| High ( >5.6) | x | | | | | | | |
| Intermediate (3.7–5.6) | | | x | | x | | x | |
| Low (<3.7) | | x | | x | | x | | x |
| *Fiscal deficit as share of GDP* | | | | | | | | |
| High (>5.4) | x | x | | | | x | | |
| Intermediate (2.8–5.4) | | | | | | | x | x |
| Low (<2.8) | | | x | x | x | | | |

*Note*: See also tables 3.2, 3.4, and 3.8.
*Source:* World Bank data.

Thus the private sector, which had suffered—in some countries for fifty years—under continual macroeconomic mismanagement, has now increased in importance.

Private sector activity is influenced by macroeconomic policies through the level and prices of firms' outputs, the prices of their inputs, the interest they pay on debt, the wages they pay, and the exchange rates under which they operate. Even more important for economic growth, the private sector's plans for saving and investment are heavily affected by macroeconomic conditions. When prices are stable and external payments are sustainable, the private sector can more easily plan future output levels and investment. This encourages saving and raises investment levels, which has a positive impact on future growth.

The countries studied here—Brazil, Bolivia, Chile, Colombia, Ecuador, Mexico, Peru, and Uruguay—have had widely varied macroeconomic experiences. The 1980s were particularly turbulent, even by Latin American standards. All the countries in this group were affected by certain developments—the second oil shock (1979–80), adverse terms of trade due to the oil price increase and the collapse of primary commodity prices, a world recession, and the debt crisis. In table 3.1, the countries in the sample are classified according to their economic performance during 1980–93 in terms of rates of growth and inflation, and the ratio of current account deficits to GDP.

The macroeconomic policy responses of these countries to the external shocks mentioned above differed widely. In some (Bolivia, Chile, and Mexico), the shocks prompted early macroeconomic reform. In others, reform came much later. Among the early reformers, Mexico was successful in adjusting to the macroeconomic shocks; Bolivia was not. It falls into the least successful category, along with Brazil, Peru and Uruguay. Both Chile and Mexico had markedly low inflation rates and intermediate to low current account deficits. These multiyear averages mask strong policy adjustments, however; many of these countries have registered improved performance in the past few years, especially Peru, while others, such as Mexico, have recently experienced renewed difficulties.

## Results of the Private Sector Surveys

In the firm-level surveys, entrepreneurs in Brazil, Chile, Colombia, Ecuador and Uruguay identified macroeconomic conditions as a crucial factor affecting business. Large variations in output and raw material prices, wage rates, the cost of capital, and exchange rates make contracting much more difficult for these firms, particularly because mechanisms to hedge against uncertainty are not readily available in these countries. The result was lower levels of economic activity.

The degree of macroeconomic uncertainty varies across countries and across time in the same country. Chile, for example, following the initial reforms of the mid–1970s, has maintained remarkable macroeconomic stability, despite the reversals of the early 1980s. Bolivia, in one of the most remarkable stabilization episodes of modern times was able to rapidly bring down inflation rates after years of high inflation and a period of extreme hyperinflation. Consequently, private firms in Bolivia ranked macroeconomic policies below other factors affecting their behavior such as infrastructure, availability of credit, and the regulatory environment. At the other end of the spectrum, Brazil has long experienced macroeconomic instability, and the episodic attempts at stabilization during the mid–1980s and early 1990s had only temporary effects. Furthermore, the confiscatory nature of these reforms interfered with property rights in a manner that undermined the contracting environment. Consequently, firms in Brazil ranked macroeconomic uncertainty as the most important factor inhibiting their development. However, Brazil's most recent reform (introduced in 1994), unlike the earlier episodes, did not interfere in contractual arrangements; as a result, it appears to have been more successful.

## Macroeconomic Policies and the Private Sector in the Early 1980s

By the early 1980s the private sector throughout Latin America faced a hostile economic environment. Figures 3.1 through 3.7 provide a cross-country comparison of the region's macroeconomic situation between 1980 and 1993. Even Chile, after adopting a development strategy centered on the private sector in 1974, temporarily had to raise tariffs, bail out commercial banks, and suspend external borrowing in 1981, in order to address inconsistencies between its exchange rate–based stabilization program and other macroeconomic policies. The result was a deep recession GDP fell by 15 percent in 1982-with disastrous consequences for Chile's private sector. (The subsequent recovery, although slow, was long-lasting.) Colombia faced a balance-of-payments crisis in 1982 as a result of falling coffee prices and fiscal excesses, and was forced to reintroduce many trade restrictions. The Colombian economy, despite its impeccable record of macroeconomic stability in earlier decades, saw higher levels of inflation throughout the 1980s.

Mexico's suspension of payments on its foreign debt heralded the debt crisis in 1982. With support from the U.S. Treasury, Mexico subsequently took steps not only to restore macroeconomic viability but also to institute a host of other reforms, including trade and fiscal reform and privatization of more than 500 public enterprises. In Bolivia, Peru, and Ecuador populist and philosophical antipathy to the private sector, as well as continuing mac-

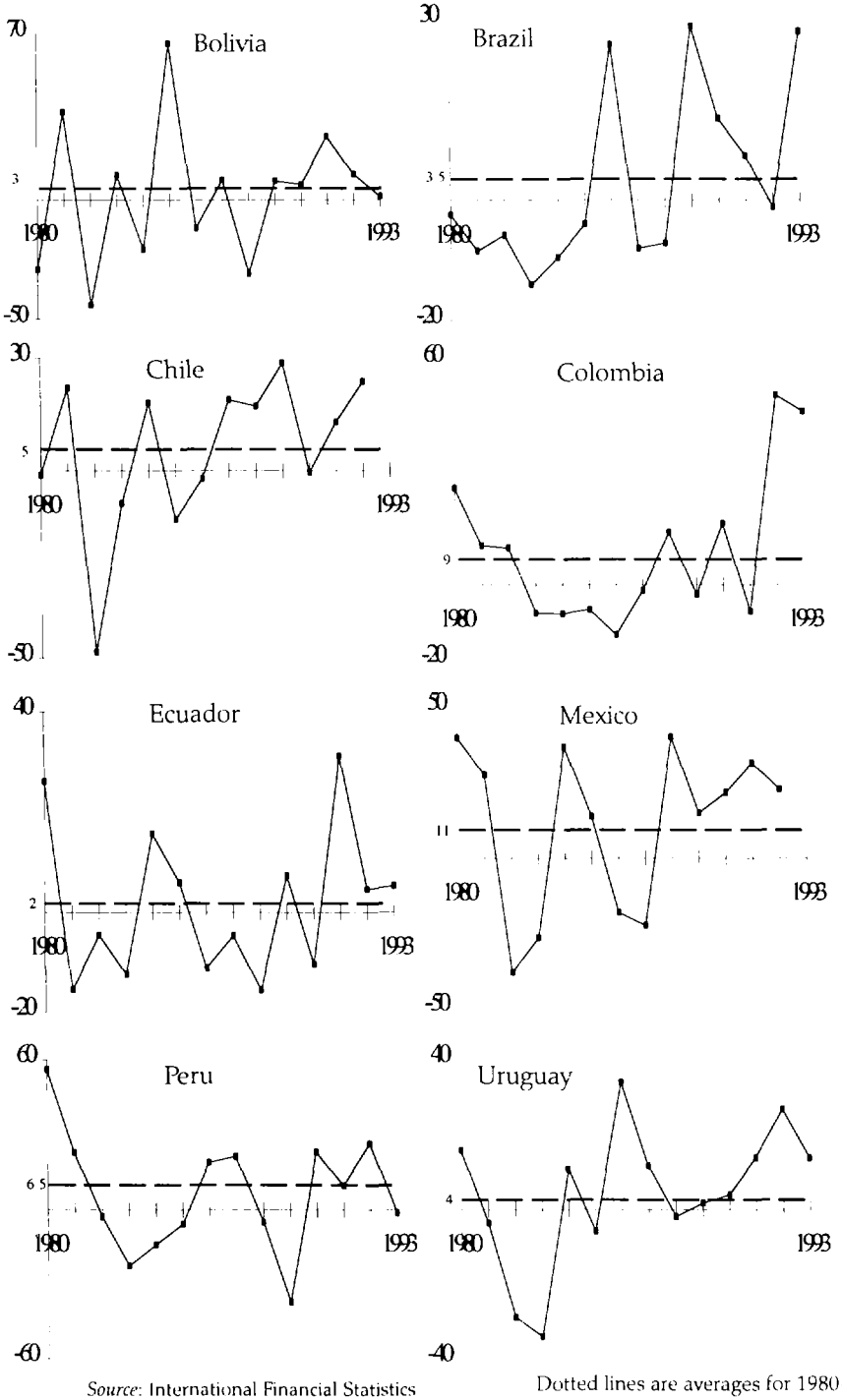
roeconomic instability, had adverse effects on the business environment; prices rose rapidly, balances of payments became unsustainable, and policy uncertainty was pervasive. Uruguay tried an exchange rate–based stabilization but ended up with high inflation, large current account deficits and stagnant output.

The turbulent economic environment had a dampening effect on private sector activity across the region. Slow growth in total output meant that the private sector's share of GDP—imports, investment, and savings—fell relative to the public sector's share. Meanwhile, growing public expenditures, which were unmatched by increases in revenues, led to large fiscal deficits. Declining output and reduced real returns on domestic assets due to inflation led to reduced private savings. The most drastic decline in savings was observed in Chile, where domestic savings fell by 42 percent in 1982. In contrast, there was only a minor decline in Brazil because the decline in income was mild and returns to savings were more or less protected by the indexation of financial assets.

All countries in the group except Colombia experienced declines in private investment during the early 1980s. This was especially apparent in 1983, when the declining income, a falling off of foreign borrowing due to the debt crisis, rising international interest rates, and general declines in private sector confidence began to affect private investment. The average ratio of private investment to GDP during this period was only 13 percent, in part because of the past bias toward public investment and ownership. In many countries, the prevailing statist philosophy had led to an inordinate extension of government authority. Investment ratios in Bolivia, Colombia, and Peru, for example, were much lower than the regional average.

Another phenomenon of the crisis years was the decline in imports, which contributed to a fall in output. Drastic import cuts were evident in 1982: 48 percent in Chile; 44 percent in Bolivia; 38 percent in Mexico; and 29 percent in Uruguay (figure 3.1). During 1983, all countries in the group except Colombia had to cut imports further to meet debt service obligations. Among the primary instruments used to reduce imports was quantitative restrictions. These disrupted private sector production, as essential imports of inputs, capital equipment, and spare parts became hard to obtain. Some governments, including those of Bolivia and Mexico, enforced quantitative restrictions on almost all imports during this period. By 1983 the growing external payments crises and ensuing inflation led to credit crunches in Bolivia, Chile, Mexico, Peru and Uruguay. In that same year, Brazil, Colombia, and Ecuador experienced increases in private sector credit; only later was domestic credit tightened in these three countries as part of stabilization programs to help eliminate the high inflation that resulted from the fiscal deficits. When credit was squeezed overall, credit to the private sector was always squeezed more because the allocation of credit was not market-determined at that time except in Chile, where interest rates were allowed to

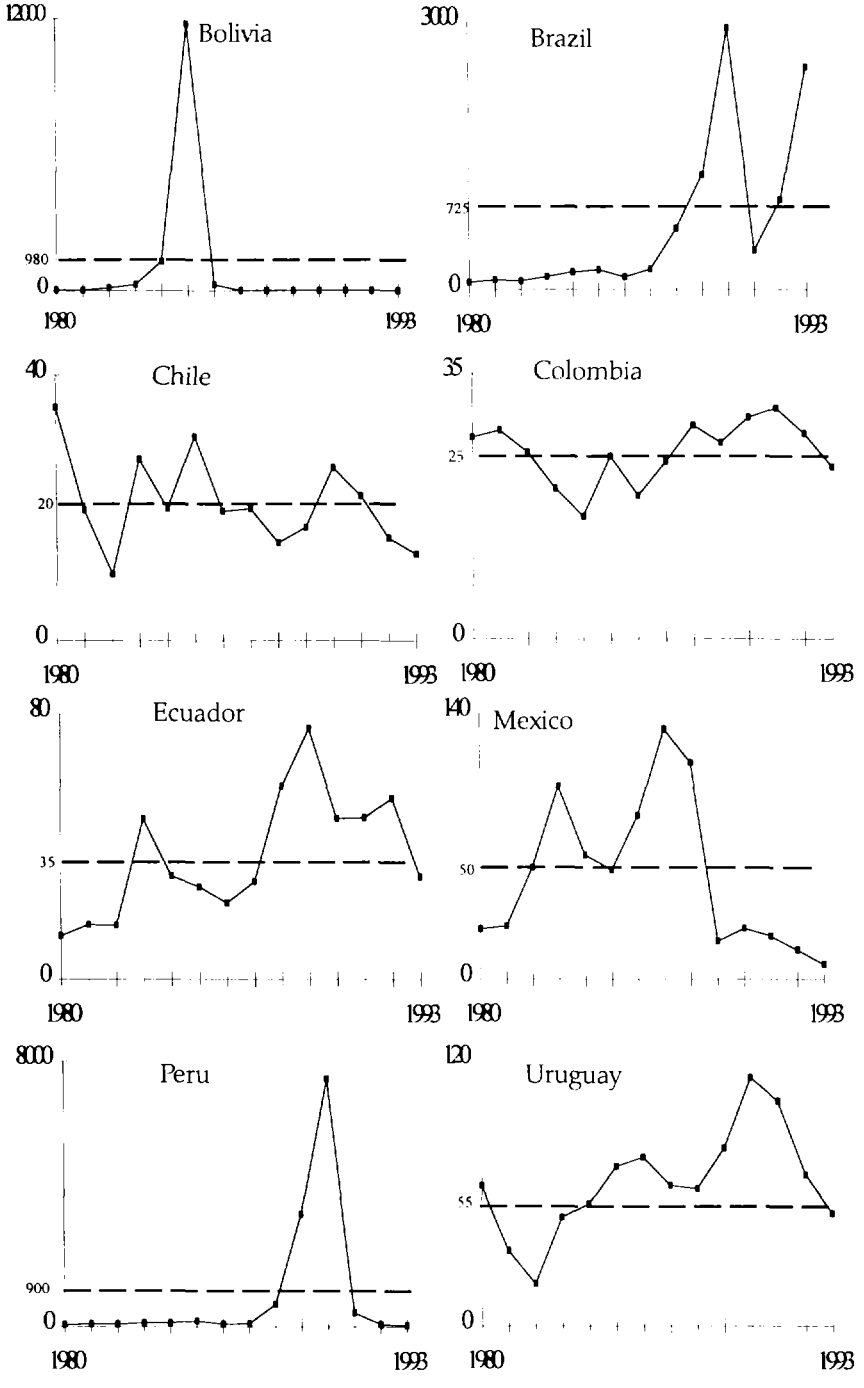
**Figure 3.1 Growth of Imports, 1980–93**




*Source*: International Financial Statistics

Dotted lines are averages for 1980-93

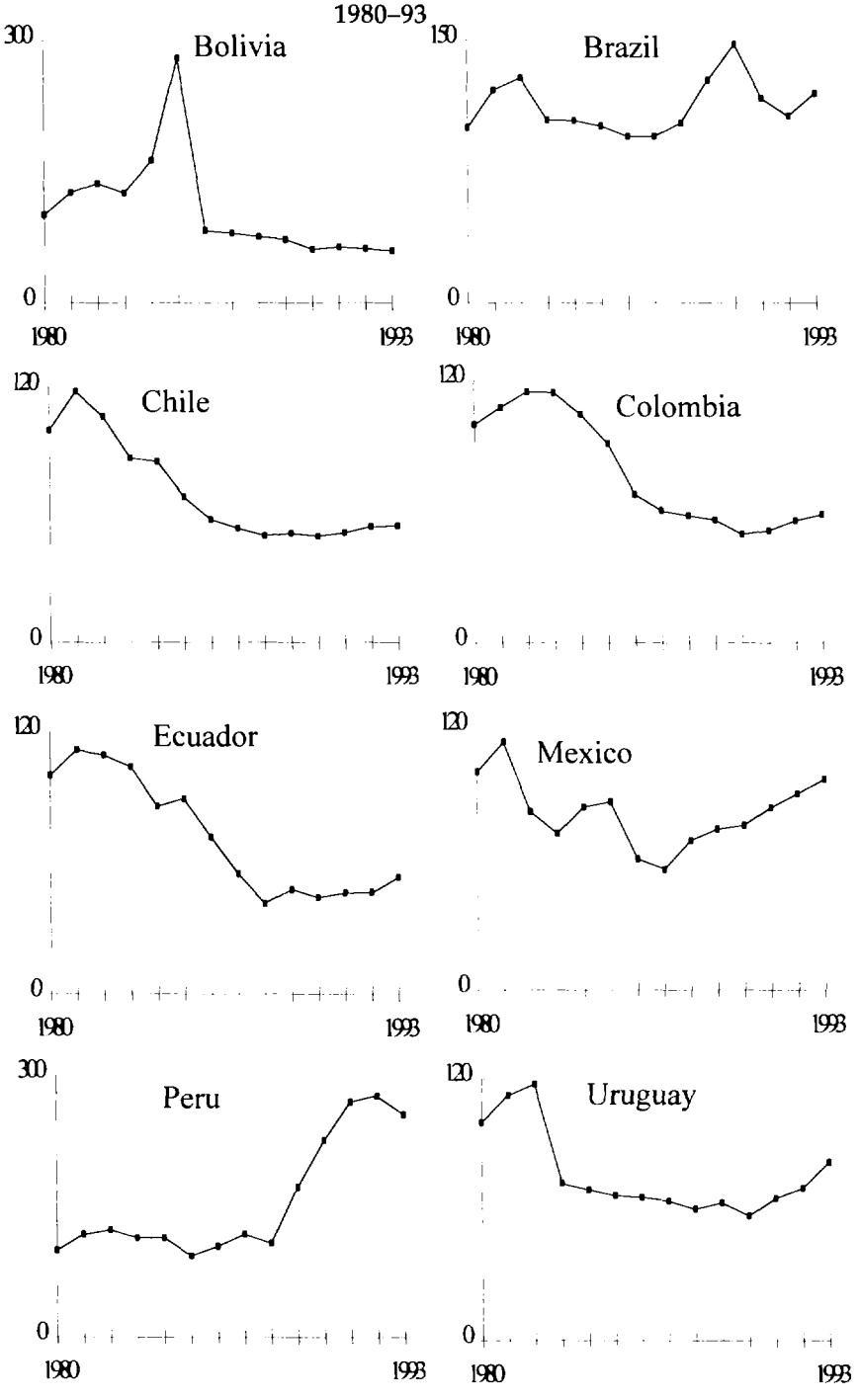
**Figure 3.2 Inflation Rates, 1980–93**




*Source*: International Financial Statistics

Dotted lines are averages for 1980-93

**Figure 3.3 Percentage Change in Real Effective Exchange Rates, 1980–93**




*Source:* International Financial Statistics

rise to very high levels. In the other seven countries the primary instrument for controlling credit was a ceiling on bank lending administered by the central banks in collaboration with ministries of finance.

Relative prices were highly volatile in this period because of high inflation, unstable real exchange rates, and rising wages. The predictability of relative prices made production and investment planning difficult. All the countries experienced high inflation (figure 3.2), and Bolivia, Brazil and Peru experienced hyperinflation after foreign credit was virtually cut off and an inflation tax was imposed through the rapid creation of money. Colombia and Chile had the lowest inflation rates among the eight countries, but even their average annual rates of inflation exceeded 20 percent.

Real effective exchange rates (nominal exchange rates corrected for the world and domestic inflation rates) fluctuated widely in the countries that experienced greater price instability (figure 3.3). This made export and import activities more unpredictable and therefore made planning for output and investment in the tradable sector more difficult. The largest real exchange rate appreciations were experienced in Bolivia in 1985, in Peru in 1992, and in Brazil in 1990. Brazil continued to follow a crawling-peg exchange rate regime, and as a result the fluctuations in the real exchange rate were closely linked to adjustment in the nominal rates. Fluctuating exchange rates also caused swings in the relative profitability of producing for the domestic or the foreign market.

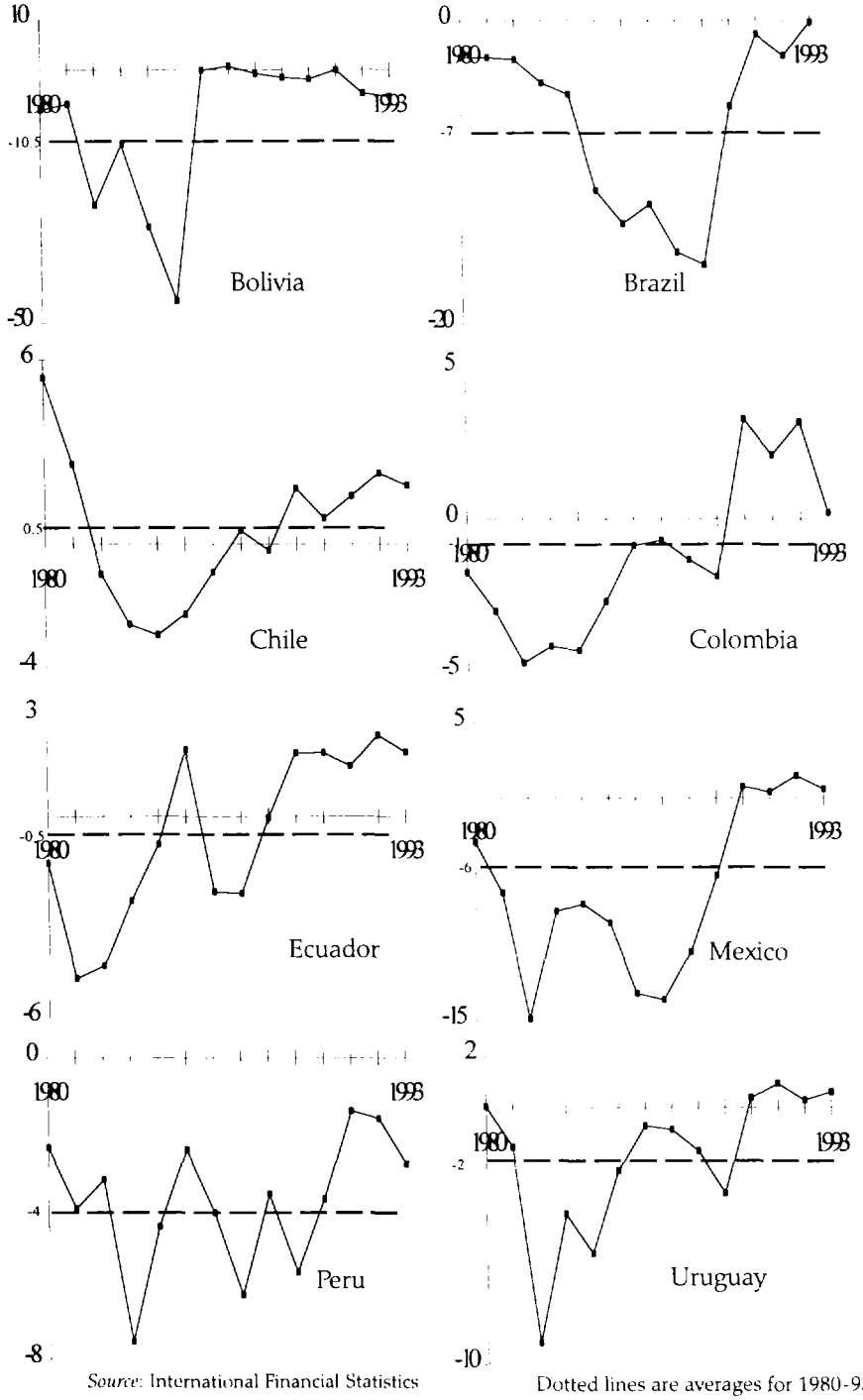
## Macroeconomic Reforms in the Late 1980s and Early 1990s

A fundamental change in economic strategy occurred in Latin America in the late 1980s and early 1990s. The public sector–oriented development strategy that had prevailed until then, which dated back to the Great Depression, had received intellectual justification and sanction in the 1950s from the Economic Commission for Latin America. During the 1980s this strategy was unable to deliver better growth and to deal with the crises of the period—long periods of stagnation, falling income levels, rising inflation, and unsustainable current account deficits. Latin American policymakers began to evaluate the potential benefits of a private sector–led development strategy. Chile had led the way in the 1970s, but the other seven countries had little experience with private sector–based development. They had less fiscal discipline, and lacked market-clearing approaches to setting exchange rates, interest rates, and wage levels.

### *Fiscal Reform*

The adoption of a private sector–based strategy created a new environment for macroeconomic policymaking that profoundly influenced private sector activities in these countries. Macroeconomic imbalances had been caused

**Figure 3.4 Fiscal Balance to GDP Ratio, 1980-93**




*Source*: International Financial Statistics

Dotted lines are averages for 1980-93

mainly by the explosion of fiscal deficits in the early 1980s (figure 3.4). For example, Bolivia's deficit exceeded 45 percent of GDP in 1985. Addressing these imbalances became the first step in reform during the mid–1980s and early 1990s, and the primary focus was on reducing public expenditures. Bolivia succeeded in controlling its fiscal deficit by balancing its budget on a daily basis: not a dollar could be spent that had not been raised in taxes. Less drastic but highly successful fiscal reforms also were initiated in Peru, Mexico, and Uruguay.

Many of these countries undertook tax reform as part of the process of imposing fiscal discipline. In general, they lowered marginal tax rates, extended coverage, and moved toward neutrality, thereby improving the general framework of incentives. For example, Bolivia's 1986 tax reform was based on a simplified consumption tax with few exemptions. At the same time, subsidies to Bolivian public enterprises were rendered unnecessary by removing price controls on their outputs, which improved their financial positions. Peru introduced a value added tax system that was neutral among activities. Fiscal control and tax reforms were not adequately addressed in Brazil—the main reason it has been unable to stabilize its economy. But recently Brazil's inflation rate has declined sharply due to the introduction of a new currency pegged to the dollar.

Before their tax reforms, when external finance was difficult to obtain, many of the countries resorted to domestic borrowing, offering higher rates for government paper and thus raising domestic interest rates. When this source dried up, inflation financing was used. This reduced the real return on private sector financial assets, and led to an appreciation of the exchange rate and to greater macroeconomic uncertainty. Many holders of private domestic assets began to convert to foreign assets, which exacerbated the debt crisis. The debt crisis essentially originated in the public sector, at least partly because of lax fiscal policy and the availability of foreign funds, both to the state and to those public enterprises with an implicit debt guarantee from the state. Fiscal reform and privatization thus had an important effect on the business environment because greater fiscal discipline lowered interest rates, thereby allowing the private sector more access to financial markets.

### *Exchange Rate Reform*

The second strand of the reforms concerned exchange rates. Inflation in the presence of fixed exchange rates had led to strong appreciation of real exchange rates, but this was corrected during the mid–1980s and early 1990s as almost all the countries freed their exchange rates: Bolivia in 1985, Chile in 1982, Colombia in 1991, Ecuador in 1992, Peru in 1991, and Uruguay in 1990. Mexico continued with a fixed exchange rate but widened the band in the 1990s, and Brazil retained a crawling-peg exchange rate. Adoption of

flexible exchange rates prevented currency appreciation from being a result of rapid inflation, although large capital inflows in the early 1990s caused real appreciations in most countries. The adoption of market-determined exchange rates helped to reduce the relative attractiveness of nontradable sectors and eliminated much of the private sector opposition to trade liberalization.

While all the countries except Colombia, which had a crawling-peg system, adopted flexible exchange rates, Argentina, Brazil, and Mexico adopted fixed exchange rates as a means of stabilizing their economies. Brazil and Mexico had to abandon the fixed exchange rate, also known as the nominal-rate anchor, approach to stabilization. Brazil's attempts in 1986 and 1991 to stabilize through a nominal anchor approach failed, but a third attempt was made in 1994. As of April 1995, the Brazil "Plan Real" was showing signs of strain as the government reimposed some import controls. But Mexico faced a serious crisis in January 1995 with its narrow-band exchange rate, which at endpoints of the band mimics a fixed rate. Mexico's balance of payments was put under tremendous pressure with large capital outflows that necessitated a rescue operation led by the U.S. government. Argentina's fixed exchange rate has held up well.

*Financial Reform*

The third strand of the reforms involved the financial and banking sector. Interest, portfolio, and credit controls used in the past had led to a situation in which financial subsidies to state enterprises were the main business of the banking sector in these countries. The banking industry, dominated by large state-owned banks, was characterized by easy credit to state-owned enterprises, controls on lending to different sectors, and occasional credit crunches on the private sector during the sporadic stabilization efforts. Central banks, which routinely financed fiscal deficits, were controlled by the ministries of finance. In many cases, the central banks suffered losses in lending to the public sector indirectly, leading to the phenomenon known as quasi-fiscal deficits.

Reform of the financial markets was radical in many of these countries. The result was that monetary policy could be used as an effective macroeconomic policy tool, the private sector had equal access with public sector enterprises to the domestic credit market, and fiscal discipline was possible since the central banks were no longer expected to finance public deficits. Bolivia, Chile, Colombia, and Mexico gave their central banks statutory power to become independent. Chile undertook far-reaching changes in its financial sector during 1983–87. Many banks in Chile were insolvent after the crisis of 1981, when many firms acquired control of private commercial banks and overborrowed. The government took over the banks' debts and then later privatized the banks and reformed the financial con-

trol structure, giving greater independence to the central bank. Mexico also undertook far-reaching reforms following its disastrous effort to nationalize private banks in the early 1980s. Portfolio quality remains poor, however, which increases the banking system's vulnerability to macroeconomic crises. Key elements of the reforms were the freeing of interest rates and the removal of portfolio ceilings. Later reforms in Bolivia, Colombia, Peru, and Uruguay followed similar lines, and, more recently, Ecuador adopted market-determined interest rates. In Brazil, although interest rates have been market-determined and indexed since the mid–1960s, the central bank lacks control over state banks, particularly one state-owned commercial bank. Money has been created to finance the ever-increasing fiscal deficits of the Brazilian states. This has spawned inflation, and the financial system, although highly sophisticated, remains inadequate. Financial reform is still incomplete in Ecuador and Uruguay.

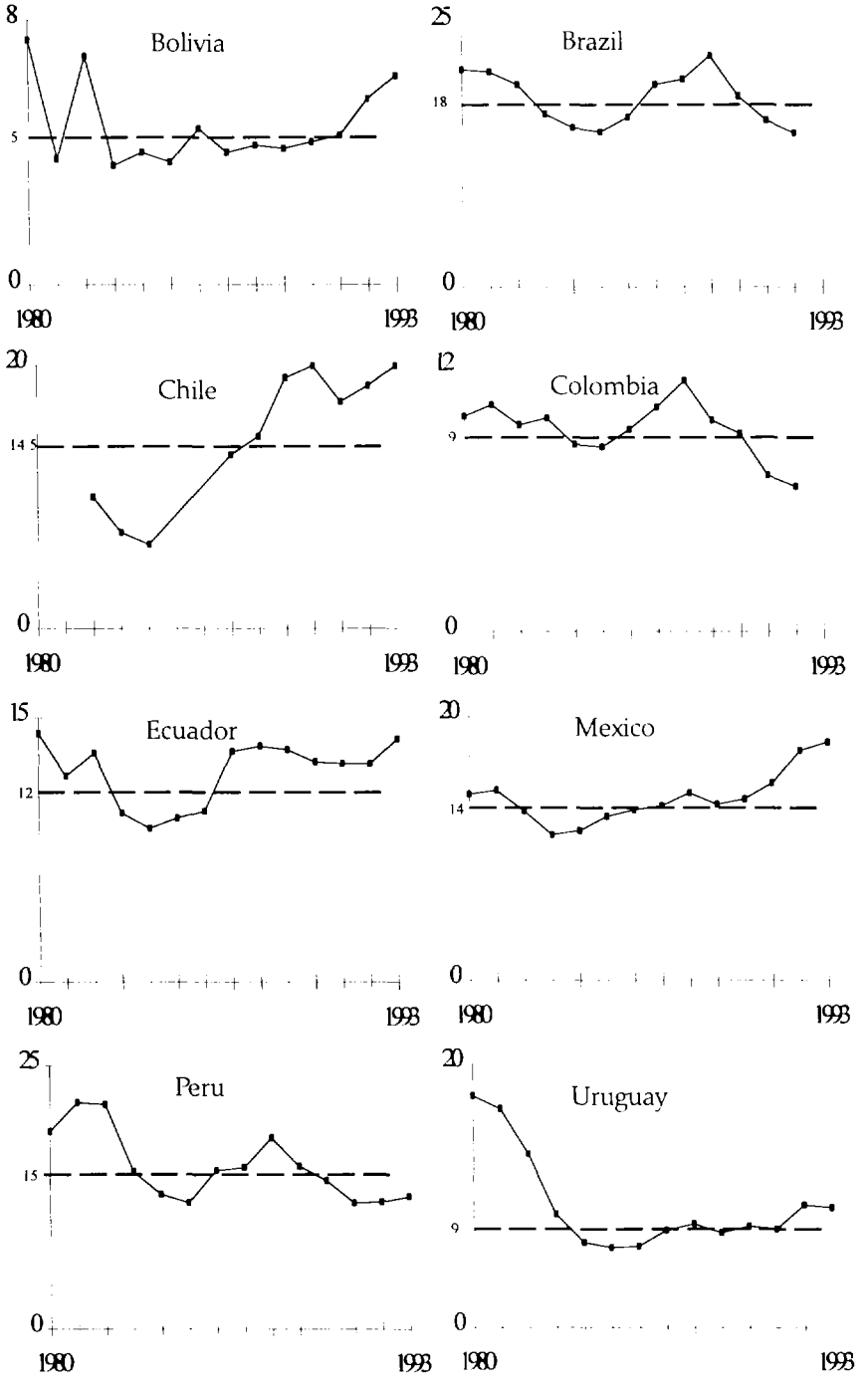
*Trade Regimes*

The fourth strand of reforms was the liberalization of trade regimes, even though, strictly speaking, trade policy is not a part of macroeconomic policy. Since the late 1980s, nearly all the countries liberalized their trade regimes so that import controls were no longer used to deal with current account deficits in the balance of payments. Consequently, greater reliance on macroeconomic policies became necessary. The tax reforms, the adoption of market interest rates and the opening of capital markets led to macroeconomic management being based on fiscal and monetary policies. These changes had positive implications for private sector development in many ways: (a) they established clear links between domestic and international prices and rendered judgments on international competitiveness by the private sector easier; (b) the bias against exports was reduced, so that exports growth was possible compared with the past decade, and macroeconomic policy was rescued from the stop-go cycle that it had fallen into; and (c) the ability to export and to generate foreign exchange resources raised the private sector's ability to borrow abroad. The average export growth rate of these countries rose to 6 percent in real terms during 1980–93, increasing the tradability of these economies. There was strong export recovery in Colombia and Chile, while Ecuador and Peru experienced slower export growth, about half of the average rate.

*External Debt*

There has been a dramatic improvement in the creditworthiness of these countries as the external debt problems of the early 1980s have been overcome. As mentioned above, the debt crisis essentially originated in the public sector. As macroeconomic reform proceeded and tightened fiscal policy,

Figure 3.5 GDFI-Private to GDP Ratio, 1980–93




*Source*: International Financial Statistics

Dotted lines are averages for 1980-93

capital inflows rapidly increased. Chile and Mexico were the largest recipients of foreign capital, initially from debt–equity swaps associated with their large privatizations. Although the improved macroeconomic environment was the main factor behind renewed capital inflows, more recently the fall in interest rates in the United States has also become important as U.S. investors have sought higher returns elsewhere. Even so, about half of the inflows are believed to be long-term investment capital, not purely "hot money" seeking the best short-term returns. Following the crisis in Mexico there has been an outpouring of short-term capital. Capital inflows to Ecuador and Peru remained relatively low because of the lower level of development in these two countries, the incomplete reform agenda, and the lack of complete confidence in the sustainability of the economic recovery. More recently, as the strength of the recovery in Peru has built up, so have capital inflows.

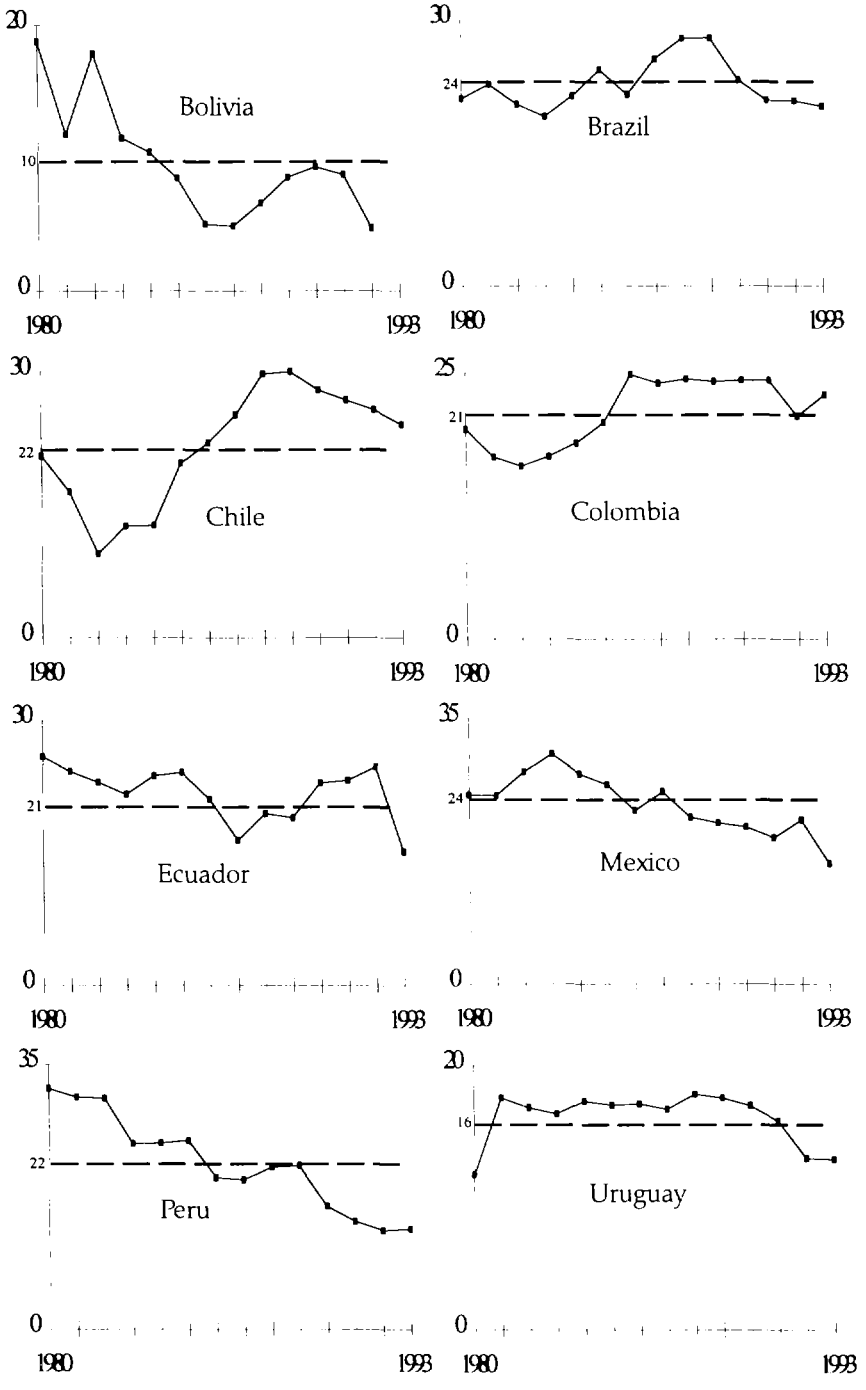
## The Effect of Reform on the Private Sector

Entrepreneurs in the countries surveyed indicated in their responses that macroeconomic stability was of prime concern to the business community. Macroeconomic conditions have improved greatly in many of these countries, and so by inference we can conclude that the private sector environment has improved. Nevertheless, the proof of this lies in the outcomes—increased output, higher private and public investment and savings, and reduced current account deficits and inflation. There has been a tremor following the Mexican crisis.

Among the group, Chile has led the way in output growth. There has been a steady recovery in output in Chile since as early as 1984—the result of the private sector–based development strategy instituted in the mid–1970s. The important story from Chile's experience is that the private sector has responded well to stable macroeconomic policies combined with strong incentive reforms. Output growth in Colombia has been the most stable in the western hemisphere. But here the strong growth was due more to the private sector's recovery following the reduction in coffee prices in the early 1980s than to changes in macroeconomic policies.

Despite strong reforms, output growth among the other countries has been relatively weak. Put another way, the supply response to reforms has not been strong. Bolivia is perhaps the best example of a country where radical reforms failed to evoke equally strong supply responses and where GDP growth has remained below population growth for the whole period. Brazil, Peru, and Uruguay also have had weak output growth compared with the average growth rate for the group. For Brazil, the high macroeconomic instability that followed the stellar growth of the 1960s and 1970s seems to be the primary reason for low growth. After initially responding slowly, Peru has recently recorded very strong growth, with the private sector playing

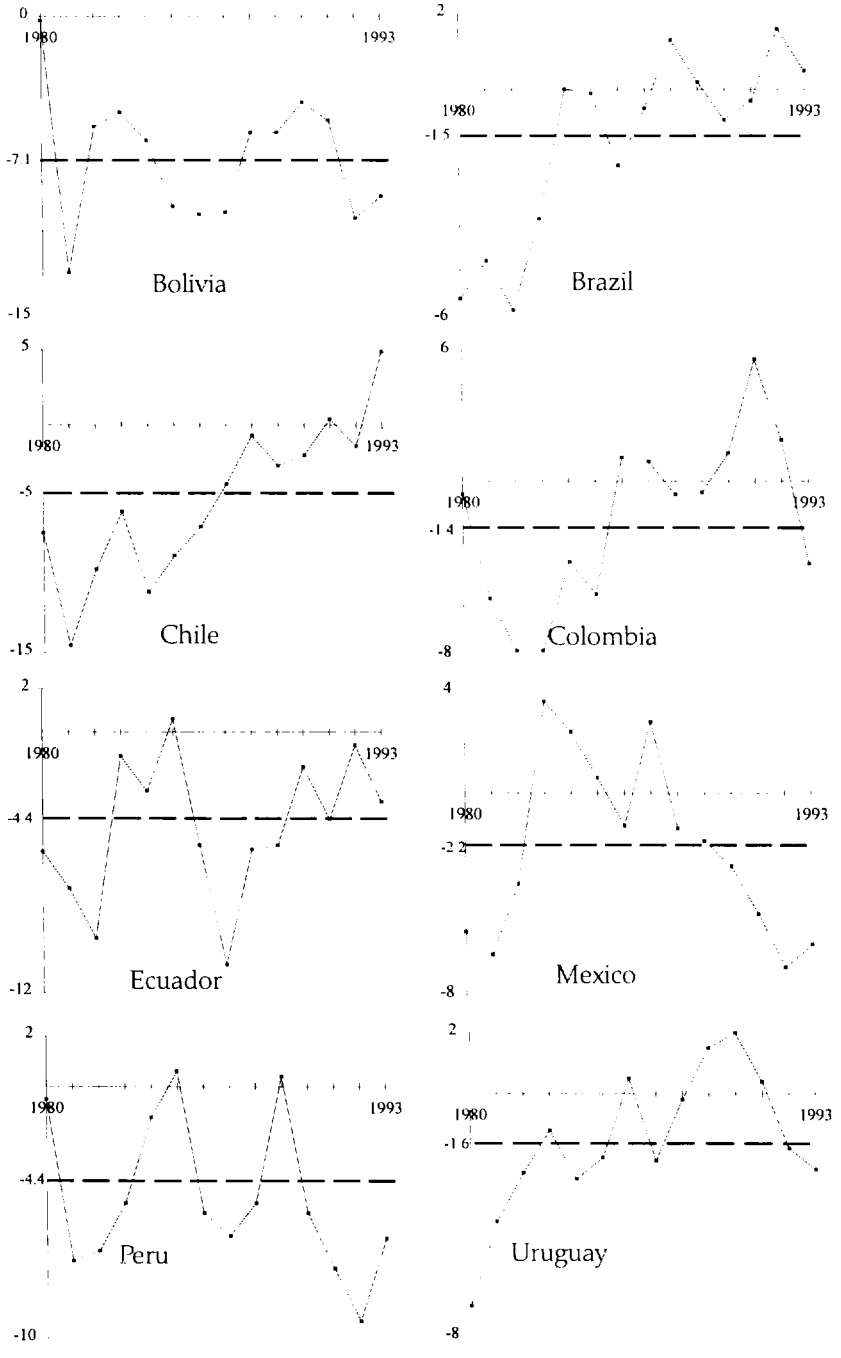
**Figure 3.6 Gross Domestic Savings to GDP Ratio, 1980–93**




*Source*: International Financial Statistics

Dotted lines are averages for 1980-93

**Figure 3.7 Current Account Deficit to GDP Ratio, 1980–93**




*Source*: International Financial Statistics

Dotted lines are averages for 1980-93

the key role in this recovery.

The clearest signs of the changing role of the private sector and its response to greater macroeconomic stability and better incentives are found in the pattern of private fixed investment (figure 3.5). The exact pattern of new investment is hard to discern, but it seems reasonable to assume that increases in investment in these countries have been related to improved incentives for the tradable sectors. Private fixed investment began to recover within two to three years after the 1981 crisis in Chile, and the increase in confidence of private investors was apparent in the restoration by Standard and Poor's of an investment grade rating to Chilean government paper denominated in foreign currency. In Bolivia private investment has not as yet recovered to its pre–1980 level, despite the strong stabilization. Private investment has actually fallen in Ecuador, reflecting the weak and delayed reforms. Private investment in Brazil has shown marked swings, which is to be expected given the continued macroeconomic uncertainty and episodic nature of the stabilization efforts. Since the early 1990s, political uncertainties also seem to have played a role in the level of private investment in Brazil. The new government, elected in 1994, has launched another stabilization plan called "Plan Real." In Uruguay the failure to reform the social security system has prevented permanent change from occurring in the macroeconomic situation, which explains the failure of private investment to recover.

There was an increase in domestic savings in most countries, starting around 1987–88 (figure 3.6). The increase was strongest in Chile and Colombia. In Mexico, savings declined with the decline in oil prices and the uncertainties brought about by the debt crisis, and their recovery has been unsteady because of fluctuations in the level and rate of growth of income and returns on financial assets. The indexation of financial assets has protected rates of return in Brazil, which is why financialized private savings have not fallen, despite continuing macroeconomic instability.

Current account deficits underwent a turnaround with the reforms (figure 3.7). During the height of the debt crisis, all of these countries had high current account deficits. Chile had an astonishing current account deficit of close to 15 percent of GDP, while Bolivia's was about 13 percent of GDP. Strong stabilization efforts led to rapid reductions in these deficits, in part through the reduction of debt service by debt-equity swaps and loans from international institutions and other sources. Increased rates of return on domestic financial assets have reduced the current account deficits and encouraged strong capital inflows, which has allowed most countries in the sample to build up their foreign exchange reserves.

Most countries in the sample enjoyed large increases in exports following the adoption of flexible exchange rates, the reduction of import protection, and the achievement of greater macroeconomic stability. The first two factors helped to reduce the bias against exports, while the third

gave producers in the export sector the confidence to expand capacity. Colombia, whose exporters benefited from the recovery of coffee prices and from better incentives, registered the highest export growth in the group. Chile, with its return to flexible exchange rates after the crisis of 1981 and its strong incentive policies, also performed well. The export performances of Ecuador and Peru have been poor, perhaps because of previous instability, the bias against exports that prevailed until recently, and the lack of an established institutional framework for exporting. As in other areas, Brazil represents a special case, since it was able to maintain moderate export growth despite continuing macroeconomic instability. This was made possible by its crawling-peg exchange rate system, which corrects itself for domestic inflation.

## Lessons of Macroeconomic Reform

This brief review of eight countries' macroeconomic policies and their effects on private sector activities leads to several policy conclusions relevant to other countries in the process of seeking to improve the environment for the private sector.

First, macroeconomic stability is essential for private sector development. Uncertainty about output, investment, prices, exchange rates, and wages inhibits private sector activities. This is evident in both the successful and the less successful countries. While Brazil is somewhat of an exception because it has grown moderately even with instability, it is clear that as the macroeconomic environment has deteriorated recently; growth rates have fallen far below those of the "miracle" years of the 1970s. Brazil has used indexation to accommodate inflation rates that have led to social collapse in other countries, but since indexation cannot be perfect, distortions in relative prices have inhibited growth by slowing productivity.

Second, while macroeconomic stability is necessary for private sector development, it may not be sufficient. This is suggested by the experiences of Bolivia and, more recently, Mexico. Both have been able to stabilize their economies but have little to show for it in terms of GDP growth. While the GDP growth in Mexico recovered in 1994, it appears to have been a demand-created boom that also contributed to the crisis in early 1995. Clearly, other factors are important for growth, such as the incentive framework, the security of property rights, and the stability of institutions.

Third, the private sector needs to be assured of the continuity of policy regimes. Reforms may have to be in place for some time before the private sector is convinced they are permanent. The longer the period of instability prior to the institution of reforms, the longer it will take to convince the private sector of the permanence of the reforms. This may be why the early reformers have not necessarily been successful.

Fourth, supply responses in the form of output growth, saving, investment, and exports depend on a host of other factors related to the regulatory environment, access to capital, and the quality of infrastructure. When there are constraints in these areas, stabilization alone is insufficient to engender a strong supply response.

Finally, the private sector requires an environment that enables it to respond and adapt to new challenges. The flexibility of the economy, the viability of contracting, and the ability of labor markets to adjust smoothly to new demands are complements to macroeconomic policy. One cannot work well without the others. Where incentive reforms make economies more flexible, macroeconomic policies have more powerful consequences. For example, inflation can be reduced at a lower cost in terms of forgone output and employment, allowing the private sector to grow to its full potential.

# 4
# Trade Policy Reform

The 1980s marked a radical shift in Latin America's trade orientation. Several decades of excessive protectionism had resulted in inefficient, high-cost economies. Earlier, short-lived attempts to liberalize were reversed, mostly due to macroeconomic crises, but also because of a lack of commitment to liberalizing trade. The Reform efforts that began in the 1980s, however, have made Latin American economies some of the most open among developing countries.

The main instrument of liberalization was reduction of the bias against exports, through reductions in import duties and devaluation of exchange rates. Output was no longer limited by the size and growth rate of the domestic market but by export prospects. Consequently, the private sector undertook new investments in the tradable sector, re-established connections with the international market and boosted export activities. In addition, trade liberalization enhanced productivity by allowing the economy to absorb new technologies from abroad and to increase specialization. This new knowledge represented a competitive asset for firms that had previously operated only in their domestic market.

## Changes in Trade Policy Regimes

Chile was the first to begin extensive trade reforms, in 1974. By 1980 Chile's trading system was transparent and open, with a low uniform tariff rate of 10 percent and no quantitative restrictions. The fast-track approach to trade liberalization, under which reforms are instituted simultaneously rather than sequentially, was followed by Chile (1974), Bolivia (1986), Mexico (1987), Colombia (1990), and Peru (1990). Brazil (1991), Uruguay (1991), and Ecuador (1993) followed at a slower pace.

Trade liberalization included the reduction of both maximum and average tariff rates. The current unweighted average tariff has fallen to around 20 percent (table 4.1). Tariff dispersion also was dramatically reduced, re-

**Table 4.1 Average Tariff and Nontariff Protection (1985–92)**

| | Average percent tariff protection[a] | | Average percent coverage of NTBs[b] | |
|---|---|---|---|---|
| | 1985 | 1991–1992 | 1985–1987 | 1991–1992 |
| Bolivia | 20 | 8.0 | 25.0 | 0 |
| Brazil | 80 | 21.1 | 35.3 | 10 |
| Chile | 36 | 11.0 | 10.1 | 0 |
| Colombia | 83 | 6.7 | 73.2 | 1 |
| Ecuador | 50 | 18.0 | 59.3 | n.a |
| Mexico | 34 | 4.0 | 12.7 | 20 |
| Peru | 64 | 15.0 | 53.4 | 0 |
| Uruguay | 32 | 12.0 | 14.1 | 0 |

a. Average total charges (tariffs plus parataríffs), unweighted
b. Unweighted nontariff barriers
*Source*: Edwards 1993, p. 59.

ducing the variance in protection across sectors. The range between minimum and maximum tariffs was narrowed, although in some cases this implied increased import duties. The number of tariff bands among these countries was reduced to between three and five classifications (except for Brazil, which has nine tariff rates). This reduced variance increased the transparency of domestic protection, and diminished the likelihood that certain sectors would receive preferential treatment at the expense of others.

Quantitative restrictions and other nontariff barriers were almost completely removed in the eight countries. In some cases, quantitative restrictions were replaced by value-added tariffs that were subsequently reduced. Most of the remaining nontariff restrictions cover imports of agricultural products; countries like Mexico have argued that these products still require special protection. Colombia also retains some agriculture protection through a system of reference prices for eight commodities.

Export promotion policies were a part of the liberalization process. Duty drawbacks were widely introduced as an incentive for export activities in all the countries. Mexico and Uruguay offered additional tax rebates for exports, as well as exemptions from such indirect taxes as the domestic value added tax (VAT). Export trading companies in Brazil and Mexico received fiscal incentives for facilitating and supporting export activities.

Duty-free zones have been established to promote exports by means of fiscal and other incentives to producers in these zones. Colombia has passed legislation to allow 100 percent privately owned and managed free-trade zones for industrial goods and services, tourism, and technology. Companies operating under this regime enjoy an income tax holiday of 30 years and will be able to use the duty-drawback regime under the "Plan Vallejo."

**Table 4.2 Merchandise Export Trends by Type of Product (1987–92)**
(annual percentage growth rates in current dollars)

| | Primary products | Semi-manufactures | Manufactures | Total |
|---|---|---|---|---|
| Bolivia | 0.0 | 15.3 | 54.9 | 6.0 |
| Brazil | 1.9 | 5.3 | 9.4 | 6.5 |
| Chile | 16.0 | 12.8 | 26.2 | 14.7 |
| Colombia | 3.8 | 3.7 | 18.0 | 6.6 |
| Ecuador | 10.5 | -11.2 | 22.2 | 7.9 |
| Mexico | -0.3 | 5.0 | 13.2 | 5.8 |
| Peru | 5.9 | 20.8 | 19.5 | 14.5 |
| Uruguay | 3.4 | 10.3 | 5.1 | 6.1 |

*Source*: ECLAC 1994, pp. 68–69.

Mexico has had duty-free zones since 1965 in which *maquiladora* (in-bond assembly manufacturing industries that produce for export) plants operate. During the late 1980s and early 1990s *maquiladoras* flourished as a result of increased government fiscal and financial support and infrastructure investment. In 1992, 40 percent of Mexico's manufactures exports originated in the *maquiladora* sector. Peru also passed regulations to implement duty-free zones and areas of special trade development, and Bolivia and the Republic of Korea have already started to invest in them. Uruguay has nine authorized duty-free zones operating under private administration, exempt from local income tax and the national net worth tax. These duty-free zones have attracted investment from export-oriented firms producing labor-intensive goods with low transport costs, such as garments, electronic products, and processed foods. (See table 4.2 for comparative growth rates by country.) The record of these zones has been mixed; reduction of import tariffs and exchange rate depreciation have been more powerful incentives for export growth.

Financial incentives have encouraged the expansion and diversification of nontraditional exports, particularly manufactures exports. Brazil, Colombia, and Mexico have supported the development of foreign trade banks to provide easy access to export credits. Credits for the pre- and postshipment stages have become available in Brazil, Chile, Colombia, Mexico, and Uruguay. However, such instruments have been oriented mainly toward exporters of final goods, and domestic suppliers of inputs for the export sector have not enjoyed the same kinds of financial benefits.

## The Exchange Rate

Exchange rate instability has often been associated with a subsequent reversal of liberalized trade policies. A stable and competitive exchange rate is therefore critical to maintaining long-term growth in the tradable sector. Uncertainty about the level of the real exchange rate, or its range of variation, makes the private sector reluctant to invest in the tradable sector. At the outset of these reforms, countries with multiple exchange rates, such as Mexico, gradually unified them into a single rate, to reduce the discretionary element of governmental action.

All the countries except Brazil, Mexico, and Peru implemented a strong depreciation of the real exchange rate at the beginning of their reforms. Mexico and Peru devalued later, and Brazil has continued with the crawling-peg rate that has been in place since 1964. Flexible exchange rate regimes, therefore, are currently in effect in seven of the eight countries. A flexible exchange rate reduces uncertainty about possible devaluation, which can inhibit trade flows and loans contracted in foreign currencies. Chile established a flexible band around a daily reference rate set by the central bank. Colombia embraced a "dirty float" system for greater flexibility, while Mexico and Uruguay adopted a floating band. Bolivia, Ecuador, and Peru maintain floating exchange rate regimes with central bank intervention. However, increasing capital inflows and the resultant exchange rate appreciation since the early 1990s may make it difficult for these countries to maintain current levels of export growth.

## Reform of Trade-Related Institutions

In most countries in the group, foreign trade policy is planned and administered by agencies linked to the ministries of finance, trade, industry, and agriculture, which allows a more coherent policymaking process. Institutional arrangements for decisionmaking on trade policy differ in each country. Brazil, Colombia, and Mexico define their trade policies through ministerial governing councils specifically in charge of foreign trade. Colombia created a new foreign trade ministry to keep trade policymaking under a single entity. These changes were meant to give more independence to trade policy and to avoid having trade policy used as a substitute for macroeconomic policy. Private producers' organizations have participated in the ministerial governing councils for foreign trade in Brazil, Colombia, and Mexico. In other countries the private sector has participated indirectly in trade policymaking through sectoral bodies (Brazil since 1990) or consultative bodies (the Foreign Trade Council in Chile since 1990). Closer contact between the public and private sectors has helped to assure the private sec-

tor that the reforms will be consistent and long-lasting. Most governments in the region have consolidated export-promotion activities into a single institution that provides the private sector with information, finance, insurance, and assistance in establishing production facilities abroad. For example, Mexico strengthened its Bank of Foreign Trade to support private sector export activities. In spite of such changes, however, the private sector in most countries continues to find the public sector's support for export promotion and finance insufficient, mainly because of the lack of financial resources and because the liberalization process is proceeding faster than the corresponding institutional transformations.

**Box 4.1 A Costly Mistake**

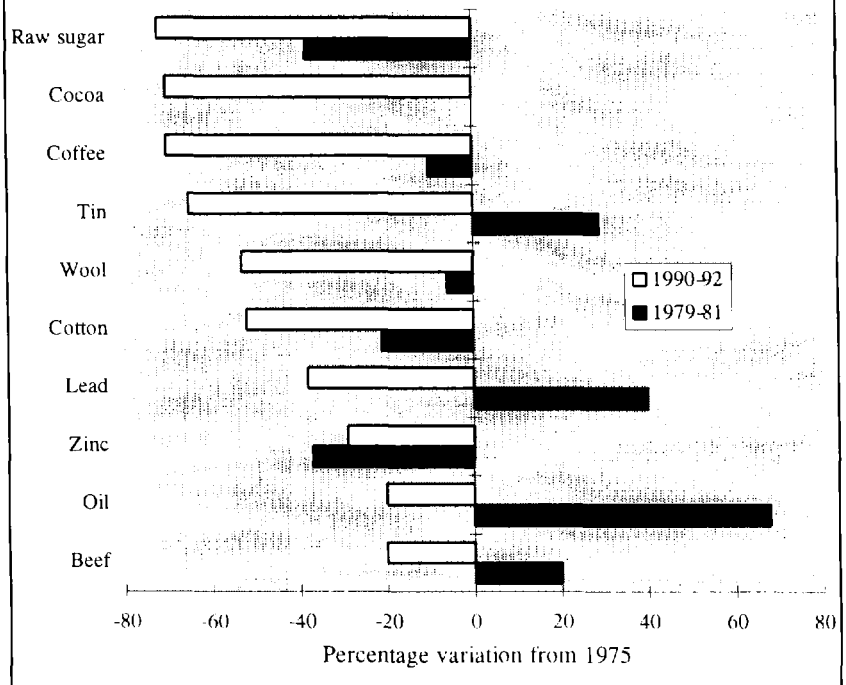
A case of overzealous rule enforcement by middle-level customs officials in Peru illustrates the harmful effects of cumbersome customs procedures. A successful warehousing company sought to renew its operating permit with the customs agency. Because the company submitted an unnotarized copy of the lease for their rented premises, the customs agency revoked their operating permit and published the revocation order in the official gazette. The company immediately submitted a notarized lease and appealed the suspension. It took four months to revoke the suspension, during which time the company ceased to operate. When the suspension was finally revoked, the customs agency refused to publish a notice in the official gazette that the company's operating permit was restored, saying it would harm their image. As a result, the company's volume of business fell to one-third what it had been before the suspension.

*Domestic Trade Legislation*

Brazil, Colombia, Mexico, Peru, and Uruguay currently have antidumping laws, which basically offer recourse to domestic producers when a foreign competitor sells a product below its production cost. Given the flexibility of antidumping measures as a policy instrument, there is a risk of their being used as a new form of protection by the private sector. Brazil has made extensive use of its antidumping and countervailing duty laws, which were introduced in 1987 and which conform to the General Agreement on Tariffs and Trade (GATT). For example, in 1992 Brazil conducted investigations that resulted in the application of twenty-six antidumping measures or countervailing duty actions. Colombia modified its antidumping laws to offset subsidies provided to producers in industrial countries and has used the laws as a provisional solution to customs deficiencies, distorting their original purpose. However, Colombian law is more stringent than GATT requires because in Colombia a petitioner must demonstrate actual, not just potential, injury and protection is granted for only a year, while GATT allows four years' protection. In Mexico actionable harm is defined not only as a loss

suffered by a Mexican national producer, but as any obstacle to the establishment of new domestic industries. Since 1992 Peru has passed specific rules for controlling antidumping and subsidies on imports. Uruguay has in effect had antidumping and countervailing duties based on GATT rules for the past ten years, and recent modifications allow the government to apply special surcharges against any imports that are subsidized or sold below market price.

**Figure 4.1 Real Prices of Exports**




*Source*: ECLAC 1994, p.71.

*Customs Procedures*

A basic condition for promoting growth of the private sector is expedient and fair procedures for export and import. Before the recent reforms, customs procedures had been used as a form of nontariff barrier. As part of the reform process, Bolivia, Brazil, Colombia, Mexico, Peru, and Uruguay created new customs agencies and simplified their administrative procedures to facilitate international trade. Bolivia reformed its customs adminis-

tration by simplifying all paperwork through a *ventanilla unica* or single window and by introducing private valuations; today, six customs houses account for about 85 percent of registered Bolivian trade. Brazil introduced the Integrated Foreign Trade System to fully integrate the registration and monitoring of free trade operations among all federal agencies involved in international trade. Brazil has also set up bonded warehouses for re-exported merchandise as a means of expediting export procedures. Colombia simplified its import procedures by introducing document- and sampling-based inspection, which reduced the costs of customs procedures. Ecuador enacted a new customs law to simplify import procedures. Mexico reformed its customs law to ease the interpretation of existing rules, which importers found cumbersome, and to define more precisely the role of customs authorities and customs rulemakers. Peru began a process to deregulate and simplify customs procedures; the private sector now manages customs warehouses, storage terminals, and authorized deposits. Uruguay introduced a new system for processing imports that reduces paperwork and improves the rules concerning customs classifications and valuation.

## Moving Towards Economic Integration

Between 1980 and 1992, the volume of exports grew at an aggregate annual rate of 6 percent in this group of countries, although the annual value of exports increased by only 3 percent because of the deterioration in the terms of trade. Since 1975 the export prices of most primary commodities (e.g., raw sugar, coffee, tin, oil) have decreased drastically, as shown in figure 4.1. This decline reduced trade income and put strong pressure on these countries to reorient their exports toward other noncommodity products, reinforcing a primary goal of trade reform—diversification of exports. Indeed, there has been a drastic change in the composition of exports, with manufactures and semimanufactures largely replacing primary products.

### *Agricultural Exports*

As a result of the sharp drop in prices of agricultural exports in the early 1990s, their value fell to 1979–81 levels. However, during the same period, there was considerable growth of nontraditional exports—fresh, frozen, and processed fruit and vegetables; flowers; beverages; and wines—the start of a transformation in the structure of Latin American agricultural exports. The liberalization process improved relative prices, deregulated taxes, and opened access to new processing technologies that extended the frontier of economically profitable agricultural resources. Producers in these countries developed new product varieties that were easier to transport and store. New market opportunities were developed for tropical and subtropical fruits

and their derivatives. Brazil is now a large exporter of concentrated orange juice. Chile's export success has been tied to a boom in the export of wine, apples, and grapes, jams and juices, and edible fish such as farm-raised salmon and trout. Colombia is an exporter of cut flowers, and Ecuador has shown strong growth of such exports as flowers, fresh and canned tropical fruits, and frozen shrimp. Mexico has specialized in grapes and fresh chicken, while Peru has relied on exports of fresh asparagus.

## Regional Economic Integration

Efforts to achieve regional economic integration are not new. Several attempts were made during the 1960s and 1970s (for example, the Latin American Integration Association), mainly intended to strengthen import substitution and to isolate the region from the fluctuations of the world economy. Recent attempts at regional economic integration differ substantially in that they acknowledge the need for Latin American economies to compete in the world market. Recent regional trade agreements give the private sector preferential access to their neighbors' markets. The Andean Pact, the *Mercado de la Cona Sur* (MERCOSUR), the Group of Three (Colombia, Mexico, and Venezuela), and the North American Free Trade Agreement (NAFTA) have had a direct impact on the trade activities of the private sector.

The Andean Pact was renewed in 1990 by the presidents of Bolivia, Colombia, Ecuador, Peru, and Venezuela to establish a free trade zone beginning in 1992. Intraregional trade among the Andean countries had previously been limited by administrative and trade barriers, as well as by poor transportation. The new Andean Pact is expected to open opportunities for private sector trade among member countries, although the extent of these opportunities remains uncertain. In 1992 Bolivia and Colombia sent 13 percent of their total exports to other Andean countries: Peru's share was 8 percent, and Ecuador's and Venezuela's were only 3 percent each. Peru decided in 1992 to unilaterally suspend the preferential treatment granted to imports from within the Pact. Chile, an original member, declined to participate in the renewed pact, having already reduced barriers unilaterally.

MERCOSUR went beyond a free trade zone, establishing a common market among Argentina, Brazil, Paraguay, and Uruguay as of January 1, 1995. Whether this ambitious intraregional liberalization program can be sustained, remains to be seen, given the high degree of macroeconomic instability in Brazil, which accounts for 83 percent of the MERCOSUR market's total production of goods and services.

NAFTA, entered into by Canada, Mexico, and the United States, demonstrates that countries with large development disparities are able to undertake regional economic integration. NAFTA went into effect on Janu-

ary 1, 1994, although a fifteen-year transition will precede the complete liberalization of trade of goods and services among these three economies. NAFTA has been viewed as the first stage of a broader trade liberalization process involving South and North America. Chile may be the first South American country to negotiate a free trade agreement with the United States. Colombia and Venezuela negotiated a free trade agreement with Mexico, which became effective on January 1, 1995, and Mexico negotiated a free trade agreement with Chile in 1991.

These trade agreements have spurred competition and fostered joint ventures among private sector companies in the member countries, but they may also have diverted some trade away from low-cost producers outside the region. Overall, these agreements should build up the confidence of the private sector in the permanence of reform and complement the global trade activities of companies in the region.

## Lessons of the Liberalization Process

Trade reforms undertaken during the 1980s and 1990s opened the economies of the region by reducing both tariff and nontariff protection, eliminating the traditional antiexport bias of the Latin American economies, and creating new institutions, policies, and programs to support export activity. Reform was implemented rapidly, leaving little alternative for local producers other than to adjust quickly to international competition. Rapid implementation quickly brought the benefits of a liberal trade regime to the private sector, and the depth of the trade reforms offered some guarantee of their permanence. These reforms provided both the stability and the regulatory framework that firms need to increase their efficiency so they can participate in international trade activities.

A key challenge for Latin American governments is to maintain open trade policies. Many have sought to do this by reducing the discretionary decisionmaking power of institutions involved in trade policy. The private sector needs a stable and predictable business environment to be able to react to the pattern of incentives—otherwise reform may prove unsustainable. This is a self-sustaining process: as reform spurs growth, private sector support of the new trade regime will increase. Thus it is in the interest of both business and government that the governments maintain clear and consistent policies.

The commitments these countries make in such regional trade agreements provide a framework that supports outward-oriented strategies. However, countries like Peru and Brazil are still reluctant to deepen the liberalization process, and their commitment to regional economic integration is weaker than that of their partners.

Latin American governments need to maintain competitive real

exchange rates which will guarantee that relative prices do not discriminate against exports. It also will be necessary to develop strong capital markets and financing policies to open access to credit to producers at all stages of the export process. Trade liberalization can allocate resources more efficiently when the domestic financial market is also liberalized. The success enjoyed by exporters of nontraditional products opens the window of opportunity for further product specialization and for expansion of current manufacturing activities. Development of new products and new markets can be supported by existing fiscal and financial incentives. However, the real appreciation of the exchange rates caused by capital inflows presents a more difficult challenge to export growth.

One potential danger is that the trade remedies that are being put into law in these countries could be used as a new form of protection, undermining recent progress in reducing nominal tariffs. Antidumping penalties, countervailing duties, and safeguard measures are implemented against individual firms, and they can become dangerously discretionary if the investigatory and implementation processes are not transparent.

# 5
# Regulation

In many developing countries, business activity is highly regulated. This is especially true in Latin America, with its history of widespread government interference in the private sector. Indeed, the colonial past of Latin America was replete with monopoly privileges either conferred by the Crown or exploited on behalf of the Crown.

This implied widespread regulation of economic life has created a legacy of detailed interference in economic activity by most governments in the region. In addition, the process resulted in a disrespect for private property rights, the norm being property rights created and changed by the state. Since the acquisition of these rights has usually been associated with earning large monopoly rents, private agents have had strong incentives to engage in rent-seeking activities. This was reinforced by policies of import substitution, widely adopted after World War II. Domestic markets were small and governments frequently limited the number of producers in protected industries through stringent regulation of rights of entry, as well as controls on the means of production. As a result, existing producers were able to earn significant monopoly profits in many countries. Furthermore, governments frequently reserved certain areas of economic activity, particularly those deemed "strategic," for enterprises owned by the state, sometimes in partnership with domestic or foreign firms.

The result was not competitive supplier markets but, rather, highly concentrated domestic industries that wielded significant economic and political power. This pattern of development also tended to lessen firms' concerns for quality and productivity (Birch and Primo Braga 1992).

Under ideal circumstances, regulation of markets corrects market imperfections, prevents anticompetitive practices, and protects consumers. Regulation of monopolies, for example, is considered necessary and antitrust and safety regulations can also be justified in many circumstances. However, regulation in developing economies does not usually fall under any of these categories. Instead, detailed regulation of all aspects of busi-

ness life has frequently been implemented in a heavy-handed way, resulting in significant distortions of incentives. Where specific industries have been regulated, regulators have often developed close attachments to the regulated industries and then exempted them from market forces. Either way, the result has been to foster inefficiency.

In practice, regulation frequently fails to achieve the goals of limiting market power, protecting consumers, or directing the allocation of resources in a socially efficient manner. In that case, removing or alleviating regulation often generates substantial welfare gains. In the United States, for example, recent experiments with deregulation in the airline, railroad, and trucking industries have resulted in significant welfare gains to consumers and producers (Winston 1993). Part of the failure of regulatory intervention can be attributed to regulatory capture: the regulated industries exert undue influence over regulators, increasing producers' wealth at consumers' expense. Various studies have found at least some degree of producer influence in most cases (see Stigler 1971 and Peltzman 1976). In practice, regulation in developing countries has seldom been based on considerations that come close to approximating market efficiency.

In terms of the overall business environment, the effect of imperfect regulation of natural monopolies is less important than the myriad laws, decrees and regulations that govern the way businesses are organized and operated. Direct restrictions, such as licensing requirements, taxes, and minimum wage laws, also have indirect consequences—such as the resources devoted to complying with numerous rules, the artificially high prices of raw materials produced by state-owned or highly protected enterprises, and inflexible labor inputs as a result of rigid labor laws. Firms must also deal with uneven and corrupt enforcement and keep track of frequent, uncoordinated, and even contradictory changes in regulations by different levels of government—changes not always adequately publicized. By contributing to inefficient resource allocation and restricting firms' ability to adjust to economic shocks, such uncertainty only consumes resources for compliance or avoidance and reduces firms' ability to operate efficiently. Regulation interferes with control over property rights and contractual freedom. Either complying with regulations or avoiding them often results in behavior that reduces savings, investment and efficient resource allocation, thereby reducing rates of economic growth and lowering the welfare of the very citizens that regulations were designed to protect.

In the discussion that follows, less attention is paid to the regulation of newly privatized firms, particularly natural monopolies, than to the general regulation of business that is pervasive in Latin America. This is not because monopoly and competition policy are unimportant; on the contrary, determining an appropriate regulatory structure is an integral part of successfully privatizing state-owned enterprises. However, these regulatory structures do not affect the general business environment except when

they concern the provision of infrastructure or basic services. (For an extensive discussion of utility regulation in Latin America, see Guasch and Spiller 1994.)

**Table 5.1 Regulatory Obstacles in Latin America**

| Country | Top regulatory obstacles |
|---|---|
| Brazil | Tax and labor regulations |
| Chile | Labor regulations |
| Ecuador | Customs and labor regulations |
| Mexico | Tax and environmental regulations |
| Peru | Tax and labor regulations |
| Uruguay | Tax and licensing or registration regulations |

*Source:* Private sector surveys.

## The Impact of Regulation on the Private Sector

Regulation in most Latin American countries has been haphazard, with no coherent aim or structure. This has substantially raised the cost of doing business. Surveys conducted for the private sector assessments show that regulation of business presents a formidable roadblock to private sector development in the region. Excessive regulation poses great difficulties for businesses in Latin America, as indicated by the large size of the informal sector in virtually every country. When the cost of complying with regulations far exceeds the benefits, firms abandon the formal economy. Licensing and registration costs alone constitute significant barriers to entry for new firms in many countries. If taxes and labor regulations are added to the cost of running a business, the extent of informal economic activity is understandable. Furthermore, imperfections in financial markets often make it difficult to obtain loans, which eliminates a primary reason for many firms to join the formal sector. Although other motivating factors may lead firms away from formality, the layers of rules and regulations are significant deterrents. Table 5.1 lists the regulatory obstacles in each country, as identified by firms that responded to the surveys. Tax or labor regulations, or both, are listed as significant barriers to doing business in all six countries.

### *Taxes*

Because of the cost of compliance, tax regulations constitute the most troublesome obstacle for private sector firms in many countries in Latin America, even though the actual rates of collection are not high. Companies in Brazil, for example, face some fifty taxes and levies—direct, income, and payroll. The taxes fall due at different times, and many require different bases for calculation. Most small firms are forced to hire high-cost outside accountants to prepare their taxes on a monthly basis. The response is predictable: collection rates are low, and significant resources are spent to avoid taxation. Even in Mexico, where recent reforms in the tax law have broadened

the tax base, reduced the tax rates, and simplified the entire process, many in the business community are wary of what might happen in the future, given Mexico's history of frequent changes in the tax system. If the system remains stable, taxes should disappear from the list of obstacles to growth and investment, but, if the government continues to make adjustments, any improvements may be outweighed by the costs of complying with the changes.

High tax levels also discourage compliance and encourage informality. Uruguay does not have a personal income tax but charges firms substantial wage and consumption taxes. Firms complain that the discretionary nature of these taxes confounds long-term planning. In addition, the extremely high social security tax—over 36 percent—needlessly discriminates against labor-intensive industries and encourages short-term subcontracting to avoid the payments. The social security tax has especially detrimental effects, resulting in distortions that subvert the advantages of Uruguay's labor laws, which are unusually flexible for Latin America. In Peru many informal firms are hesitant to enter the formal sector because the government requires enormous amounts in back taxes in order to regularize their status.

*Labor Regulations*

Labor regulations takes many forms, the most common of which are minimum wage requirements, mandatory nonwage compensation, and job security guarantees. Ecuadorian employers, in particular, complain of truly stifling minimum wage requirements. Only 50 percent of the labor force receives more than the minimum wage, and 20 percent of all labor disputes revolve around failure to pay the minimum. In addition, the government frequently either sets compensation directly or controls it indirectly through state-owned enterprises that compete with private firms for workers. In Ecuador the large size of the informal sector—a good indication of economic distortion and misallocation of resources—seems to be caused more by labor regulation, in particular wage controls, than by taxes or entry barriers.

Nonwage compensation raises the cost of employing permanent workers. As a result, a consistent labor market response in all countries surveyed is that firms hire temporary workers or subcontract much of their work, which reduces incentives to invest in worker training. Another disincentive for hiring permanent workers is the difficulty of dismissing workers for poor performance or because of reduced demand for firms' products. In many Latin American countries, the only acceptable causes for dismissal are theft, drunkenness, or chronic absenteeism. In Mexico all jobs are essentially permanent, and large fines are assessed against firms found guilty

of wrongful termination. For example, prospective purchasers of failed banks view the labor contracts with the banks' employees as one of the most severe disincentives to investing. Such job security laws encourage infor-

**Box 5.1 Navigating the Bureaucracy in Brazil**

*Jeito*, a Portuguese word meaning, roughly, "wangle" or "fix," is the term for the ingenious and resourceful ways Brazilians use to get around a maze of laws and bureaucratic entanglements. Such practices are found in many countries, where laws are sometimes inappropriately drafted, where the economy is rife with red tape, and where the law can become a discretionary instrument in the hands of those who seek to use it. Brazilians have a saying, "For friends everything, for strangers nothing, and for enemies, the law."

The Brazilian *jeito* is one of the rare cases of an informal institution that has been well documented (Rosenn 1984). The *jeito* can take the form of outright illegality, such as bending or breaking laws for personal gain, or indirect ways of circumventing laws in order to keep the wheels of the economy turning—for instance, a factory inspector may turn a blind eye to the official minimum wage in order to prevent a factory from going out of business in an area of high unemployment.

The *jeito* normally operates palm in glove with another Brazilian institution, the *despachante* (roughly, "expediter"), who has counterparts in many nations. The ubiquitous *despachante* lubricates Brazil's sticky administrative process and thrives as a specialized professional, with his own union and competitive examinations. Some *despachantes* handle only customs matters; others specialize in police work, naturalizations, auto licenses, marriages, or "legalization of real estate." Each *despachante* is an intermediary who, for a commission or fee, purchases and fills out a multiplicity of legal forms, delivers them to the proper people, and extracts the needed permission or document. *Despachantes* who arrange importation or exportation of goods have long enjoyed a legal monopoly. Even when a *despachante* is not required by law, it may be practically impossible to secure anything quickly from the bureaucracy without one. Obtaining necessary documents can be so difficult that it is not unheard of for one governmental agency to employ a *despachante* to extract something from another agency. The simplest transactions, such as obtaining a marriage license or identity card, may take hours, days or weeks, depending on whether one uses a *despachante* and how much he is paid.

The *despachante* is effective above all because he has cultivated friends in the bureaucracy, often by turning over a portion of his fee or by appropriate Christmas or birthday presents. Of course, if one is fortunate to have a friend, or a friend of a friend, in the right government office, the services of the *despachante* are unnecessary -- but it often appears that were it not for the *jeito* and the *despachante*, the entire administrative apparatus of Brazil would grind to a halt.

mal contracts or subcontracts, divert resources to court disputes, and create incentives for firms to operate outside the law. Moreover, they limit firms' flexibility to respond to changes in demand or to other market forces. For example, a supermarket in Peru was forced to pay its workers for one and a half years after closing a processing plant due to lack of demand.

Some constraints that firms in the region face come from union rather than government requirements. These include seniority-based promotions, industry-level rather than firm-level bargaining, and rigid job definitions. These restrictions are often implicitly supported by the government, and courts usually rule in favor of workers in labor dispute cases. In Ecuador, for example, restaurant workers assigned to lunch shifts cannot work dinner shifts, and fork-lift operators may not operate large trucks. In addition, seniority-based promotions often institutionalize unproductive practices, discourage workers from improving their skills, and make it impossible for firms to assign their employees in the most efficient manner.

**Box 5.2 The Maze of Brazilian Regulation**

Both federal and state regulations govern the installation of fire extinguishers in São Paulo. Unfortunately, the two set of regulations disagree about the height at which the extinguisher should be hung. An enterprising businessman had two hooks placed on the wall, one corresponding to the rules of each code. He moved the extinguisher to the relevant hook for the visiting inspector. He was thwarted, however, when the inspectors conspired to arrive together, discovered the violation, and elicited a payment

*Licensing and Registration Requirements*

Licensing and registration requirements represent yet another burden for firms seeking to enter the formal economy. Firms are required to obtain permits to operate and must meet certain other conditions in order to continue operations. In many Latin American countries small firms opt to remain in the informal sector, because the costs outweigh the benefits of formality; or pay bribes to circumvent some of the requirements, or hire someone to complete the steps of the process for them. The excessive paperwork involved in starting and running a business in many Latin American countries serves no economic function. Nor does the creation of an entire class of economic agents whose responsibility is to circumvent the process represent an efficient allocation of resources. Interestingly, the survey responses showed that despite Chile's more lenient licensing and registration policies, the costs to businesses in both time and money terms were much the same as in Brazil, because Brazilian firms are particularly adept in evading onerous legislation.

*Other Regulations*

In addition to regulations on licensing and labor issues, myriad regulations cover the conduct of business itself, from hours of operation to safety regulations to building requirements. These are promulgated at all levels of government and are often contradictory. Such regulations are more often observed in the breach, but they give government officials discretionary power that is frequently used for personal gain.

## The State's Failure to Regulate Itself

Much of the state's interference in economic life in Latin America has been justified on the grounds that the performance standards of the private sector need to be controlled in order to protect consumers. Ironically, these same standards have not been applied to the public goods supplied by the state itself. Indeed, the flip side of pervasive private sector regulation has been an inadequate supply of those services the state is deemed to have a comparative advantage in producing. The absence of a well-functioning judicial system has been particularly detrimental for the private sector, in that long-term impersonal contracting has been made more risky by inadequate recourse to the court system. In addition, laws often are not based on sensible economic criteria and are frequently contradictory and confusing. The courts suffer from poorly trained judges, long delays, and corrupt practices. Assets are difficult to use as collateral to secure loans, because of shortcomings in the laws and procedures for pledging and repossessing property. Similar inadequacies hamper titling and registering land and dwellings. These problems have been known and acknowledged for many years, yet the machinery of the state has proved inadequate in improving and reforming the system. Any system of regulation must allow for the proven weakness of government in this area.

## Costs and Benefits of Regulation

In regulating natural monopolies, such as utilities, the state must decide what price the provider may charge and how to ensure that the provider makes the service available to all potential consumers. If prices are set at optimal levels, the provider will serve consumers without earning monopoly rents and without needing financial support from the state. The Chilean state water company is an example of such a well-regulated monopoly, with the price determined by replacement cost. In Brazil subsidies that distorted the marginal price of power delivered to low-income rural users have

been replaced by a one-time installment subsidy, rationalizing the system and removing some incentives for abuse.

The way in which natural monopolies, in particular utilities, are regulated will determine how attractive they are to private sector investment. Many of the principles outlined above in the discussion of private sector regulation apply. In particular, the arbitrariness that has characterized government intervention in much of Latin America can be controlled by restraining the discretion of regulators and limiting their ability to change the regulatory system. In addition, regulatory systems should take into account the strength of the institutional structure within the country. Trying to impose sophisticated regulatory schemes in countries where skills are in short supply may cause the whole structure to break down. It may be necessary to reduce or even eliminate the discretionary flexibility of the regulators. Any reduction in the efficiency of regulatory structures will be outweighed by the benefits of a more stable climate for private sector investment. In short, the tradeoff between institutional endowment and regulatory efficiency requires that regulatory structures be tailored to the country's particular circumstances in order to maximize private sector involvement.

Furthermore, technological innovation is a powerful promoter of competition. For example, cellular phones and smaller-scale electric power generation units have radically changed the nature of the telecommunications and electric industries. Their introduction promotes competition in the system and reduces the need for regulation. Purchasers of newly privatized industries should not be given the right to enjoy monopolies on all forms of technology.

Anticompetitive or collusive markets require another type of regulation that maintains market pricing or ensures optimal production if firms attempt to limit competition by merging. To ensure fully competitive markets, there must be free entry and the market must set prices. Although concentration in and of itself is not sufficient evidence of cartel or oligopolistic practices, it may indicate anticompetitive or collusive agreements between firms. Maintaining an open trade regime is the most powerful method of encouraging competition for tradable goods.

Collusive behavior can be horizontal among firms or vertical between producers and suppliers. In the first case, firms agree to fix a certain price, regardless of supply and demand, or they divide the market geographically to limit competition. Vertical constraints include retail price maintenance or, again, dividing the market geographically, with each retailer paying a franchise fee to the producer. In general, industries that appear to be earning economic rents because new entrants have failed to appear must be maintaining their rents through oligopolistic agreements. These situations result in less than efficient markets, incorrect distribution of resources, and other anticompetitive outcomes that inhibit full economic development.

Cartels are often created by governments in a misguided attempt to protect a domestic industry. In Uruguay, for example, most anticompetitive procedures are government-sponsored, with the result that competition comes primarily from outside the country. In order to prevent domestic businesses from closing down, even if their net worth is negative and they carry huge debts, the Central Bank of Uruguay has made it nearly impossible for a company to declare bankruptcy. Exit barriers inhibit competition as much as entry barriers, and they effectively weaken the domestic economy. As Latin American borders open, this situation becomes increasingly dangerous for the protected economy. Uruguay appears to recognize this problem, but its solution has been to institute a trademark policy that protects only domestic markets while allowing duplication of international trademarks. A more evenhanded policy would protect both national and international brands, grant patents to encourage research and development in all fields, and prosecute rather than protect firms guilty of nonmarket practices.

Consumer protection and safety regulations, particularly concerning the environment, may be beneficial overall because there are "missing markets." If no one wants to "buy" pollution, some legislative mechanism must be installed to ensure that outputs of pollution produced reflects the cost to society of a dirtier environment. A lack of information available to consumers is another reason for the government to intervene in this area. The risk is that governments will overlegislate and prevent industry from functioning at an efficient level. If the costs of complying with such regulations are allowed to become greater than the damage done by noncomplying firms, industry might be forced to contract. Needlessly constraining the private sector carries costs for the society too.

For example, current environmental legislation in Mexico runs the risk of doing more harm than good. The Mexican government has attempted to model its environmental regulations on those of industrial nations. Unfortunately, the regulations concern only the levels of pollution produced, with little or no consideration given to the varying costs producers would face in abiding by such limits or to the varying levels of damage such pollution would cause depending on location. For the private sector these regulations are a significant deterrent to growth. Governments should make an effort to determine the potential damage to society and use this in formulating regulatory policy.

Peru has taken an innovative step to improve the protection of intellectual property, to set standards, and to implement consumer regulation: in 1993 it established the National Institute for the Defense of Competition and the Protection of Intellectual Property (INDECOPI) to serve as an administrative court of the first and second instance in most matters relating to trademarks, patents, standards, consumer legislation, and antimonopolistic practices. The aim in establishing the body was to remove

these issues from the inefficient court system and to streamline procedures for defending intellectual property. INDECOPI has a significant degree of independence and so far appears to function in accordance with its mandate.

## Lessons of Regulatory Reform

Whether the state is working to regulate or deregulate, its main purpose should be to increase competition in the economy, which in turn will increase consumer welfare and encourage private sector development. The interventionist bent of many Latin American governments in the past has meant that there has been more overregulating than underregulating. This has been partly a consequence of history and partly a consequence of the inward-looking import substitution policies of the recent past. Zero regulation may not be the answer, but the business community in most Latin American economies currently labors under onerous regulatory burdens even after the round of deregulation that has occurred as part of the economic reforms. Many in the private sector complain about the nature of the regulations, their uneven enforcement, and the unpredictability of changes, rather than about the penalties assessed. As with many other aspects of the economy, if firms can feel confident in their ability to predict future changes, they will be able to make adjustments to enhance their efficiency under most circumstances. Regulations that prevent them from adjusting, regulatory systems that are not consistent, and frequent changes in those systems all work against the economy's ability to produce high rates of growth. The three circumstances that can most often be improved by government regulation are natural monopolies, anticompetitive markets, and inadequate consumer and environmental safety. Each requires a different regulatory treatment. Governments should not yield to the temptation to go beyond the prescribed solutions and attempt further regulatory action. Furthermore, previous state failure should be kept firmly in mind in designing and implementing any programs. Respect for property rights will help to protect the private sector from the haphazard and uneven effects of regulation that has characterized the past. This theme is enlarged on in chapter eight.

# 6
# The Financial Sector

Economic growth and, in particular, the development of the private sector cannot occur without a financial system that effectively intermediates between savers and investors. A healthy financial sector allows financial resources to be allocated toward activities with high rates of return; allows for efficient intermediation, which implies lower resource costs; and yields better information processing, which allows innovative investments to be identified. Financial sector reforms during 1980–94 in the eight countries studied for this report allowed them to move from financial repression to some degree of financial health, although to varying degrees. The experiences of these countries— Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, and Uruguay—contain lessons for the relationship between the financial sector and private sector development and for future reforms.

The timing of reform, its breadth, its sequencing and pace, and its success have all varied across the countries in the sample. The prereform period was one of marked financial repression in virtually all of these countries. Interest rates were subject to controls, the allocation of credit was largely discretionary, securities markets were discouraged, and new financial institutions faced severe barriers to entry. Investment was frequently misallocated, and savings rates were low. Macroeconomic instability discouraged savers from holding deposits in the domestic financial sector. Broad money–GDP ratios were low. A combination of high reserve requirements, interest rate ceilings, and high inflation resulted in negative real interest rates which stifled savings, spurred capital flight, and encouraged investment in unproductive inflation hedges (for example, real estate), rather than in financial assets that could be mobilized to stimulate growth. Furthermore, the volume of resources intermediated locally was generally low due to speculation against the overvalued currency.

Several of the eight countries attempted reform in the 1970s, but they were generally unsuccessful because of inconsistent macroeconomic policies and the lack of prudential regulation. When the 1982 debt crisis

struck the final blow, Chile, Colombia, Mexico, and Uruguay were hardest hit. The proportion of nonperforming loans soared, in some cases to more than 20 percent of total loans. In 1981–82 Chile saw the most dramatic collapse: eleven financial institutions whose portfolios represented 15 percent of total loans were liquidated, leading to a collapse of the financial system. The government was forced to take over seven insolvent banks, liquidating two and later privatizing the rest. Uruguay experienced an insolvency crisis that nearly engulfed the entire banking sector, forcing the central bank to acquire the loans of the problem banks. The Mexican government nationalized the country's entire banking system in September 1982 and took over the banks' liabilities. Credit to the private sector diminished from 40 percent of total bank credit in 1980–81 to 25 percent in 1986.

## Financial Sector Reforms

The debt crisis and subsequent drying up of capital inflows highlighted the importance of boosting domestic savings, which had been extremely low. A new approach was needed to lay the financial basis for private sector development. Chile was more successful in rehabilitating its banking system than other countries. The 1982–85 rescue resulted neither in a major acceleration of inflation, which remained below 30 percent, nor in a surge of real interest rates, which remained at about 8 percent. This may be attributed to several factors: (a) fiscal discipline in the late 1970s and the consequently low public-sector debt in the early 1980s; (b) the greater depth of the financial sector due to the mid–1970s reform, which facilitated easier absorption of the new debt issues; (c) the significant real devaluation which improved the external account and eased pressures on restrictive monetary policy; and (d) downwardly flexible real wages associated with weak trade unions. Other countries such as Bolivia were far less successful, being saddled with hyperinflation (over 11,000 percent in Bolivia in 1985) and large budget deficits, which averaged 30 percent of GDP in Bolivia during 1983–85. Fiscal deficits severely crowded out private sector financing and investment. Similarly, in Mexico and Uruguay credit to the private sector decreased significantly as the government used commercial banks to finance the fiscal deficit. In Uruguay, the government resorted to high reserve requirements, forced loan

**Table 6.1 The Timing of Financial Reform**

| Early reformers | Recent reformers | Most recent reformers |
|---|---|---|
| Chile (1974) | Bolivia (1985) | Peru (1990) |
| Uruguay (1974, 1990) | Mexico (1988) | Colombia (1990) |
| | | Brazil (1991) |
| | | Ecuador (1984, 1993) |

rescheduling, an inflation tax, and compulsory holding of public debt by commercial banks.

The timing and relative success of financial reform varied among these eight countries. Table 6.1 breaks the countries into three groups according to when reform was undertaken. However, early reform was no guarantee of early success. Comprehensive financial sector reform was instituted by Bolivia in 1985, following implementation of a classic stabilization effort and these met with great success. Ecuador initially undertook reforms in 1984, but the reform process was stop–and–go until 1993, when comprehensive reforms were undertaken. Chile started early and succeeded. Mexico started later but succeeded relatively more than Uruguay where an earlier attempt at reform in 1974 had failed. Mexico's reform faltered recently under the macroeconomic crisis that proved banking portfolios to be weak.

Nevertheless, the leveraging of firms (the ratio of liabilities to capital and retained earnings) remains low in virtually every Latin American country, compared with those in the industrial world. This is partly the result of macroeconomic instability. When the macroeconomic climate is unstable and uncertain, companies attempt to reduce their borrowing in order to reduce risk. It is also, however, the result of poorly functioning financial markets in which firms find it difficult to borrow to finance growth. In particular, the ability to pledge movable assets (plant, raw materials, finished goods, and accounts receivable) as security for working capital finance is constrained by deficiencies in the legal framework. In the United States, 40 percent of all assets and 50 percent of new investment consists of movable assets, a far higher proportion than in Latin America. Not being able to use growth in these assets as security to finance further growth is a severe barrier to investment.

## Policies to Increase Access to Capital

The governments and the financial institutions in Latin America are well aware of the need to increase capital availability and some of the countries have taken several steps in that direction.

### *Market Determination of Interest Rates*

Deregulation of interest rates improves the efficiency of credit flows. Most countries have eliminated interest rate ceilings and let market forces determine interest rates. The interest rate has been treated as just another relative price that must be set right. Where subsidized rates are maintained, as in Mexico, these have been linked to market interest rates. The sectors where subsidies remain are generally agriculture and housing.

*Elimination of Directed Credit*

Direct credit allocation by the government has been significantly reduced, although Mexico did have some directed loans from multilateral agencies until recently. Chile and Bolivia have adopted a system under which development credit provided by multilateral institutions is auctioned to commercial banks, which has enhanced the efficiency of the subsidized credit. Another development has been the downgrading or closing of so-called development banks in many countries in the region, which represents a significant break with past policies. These banks traditionally lent at subsidized rates without adequate security on projects that had not been adequately appraised. As an arm of industrial policy, they were an important part of the inward-oriented economic policies of the prereform period. The existence of these banks hampered the development of the financial markets, because other lenders could not compete with the subsidized terms offered, and undermined the repayment ethic, as many of the loans were not repaid.

*Development of Capital Markets*

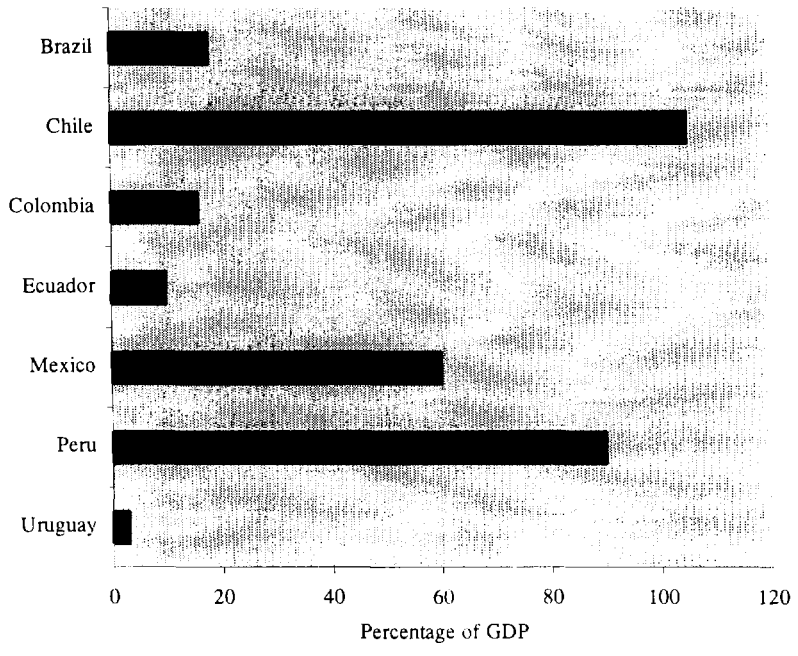
The capital market's maturity and its ability to serve private sector financial needs vary significantly among the sample of countries. In Chile the market is well developed and has been very active since 1990, providing a cheap source of finance to the private sector. Maturity of debt has risen and twenty-year mortgages are extended. Security markets received a further boost from a 1994 package of reforms. The bourses in Mexico, Colombia, and Peru are also developed, although to a lesser extent. Peru recently liberalized securities issues and trading and deregulated intermediary fees and commissions. Mexico has developed a legal and regulatory framework for asset-backed securities but still faces high transaction costs. These costs are compounded by increased uncertainty regarding the macroeconomic situation. Colombia is struggling to revive its securities market which deteriorated in the 1970s and 1980s. In the 1960s about 400 companies were listed on the Bogotá stock exchange; by 1993 there were only 89 (table 6.2). Nevertheless, firms have increasingly issued equity and bonds to obtain long-term financing. The Brazilian se-

**Table 6.2 Size of the Stock Market, 1993**

| Country or City | Number of firms listed |
|---|---|
| São Paulo | 550 |
| Rio de Janeiro | 577 |
| Chile | 263 |
| Colombia | 89 |
| Mexico | 190 |
| Peru | 233 |
| Uruguay | 17 |

*Source:* International Finance Corporation data.

**Figure 6.1 Market Capitalization, 1993**




curity market is subject to substantial distortions but is particularly sophisticated in the variety of securities available. In Bolivia, Ecuador, and Uruguay markets are thin and concentrated, and equity, bond, and money markets are virtually nonexistent. Uruguay has significant financial depth but a thin capital market, which is paradoxical given its open regime for foreign banking deposits. (See figure 6.1 for a comparison of market capitalization).

*Encouragement of Institutional Investors*

Institutional investors are important because their large funds can provide long-term finance to the private sector and can bolster the capital market. Currently, institutional investors play a major role only in Chile. The largest investors are private pension funds that developed following the 1981 social security reform. Institutional investors are playing an increasing role in Mexico since reform of pension funds (1992), investment funds (1993), and

foreign investment laws. Colombia and Peru also have recently adopted pension reform, and these funds are expected to bolster both the capital market and private sector development.

*Opening the Capital Market*

Of the sample countries, Brazil, Chile, Peru, and Uruguay have the most open policies and they have registered increasing amounts of external financing by the private sector. Mexico has certain ownership barriers to foreigners but in the context of NAFTA has seven years to phase out all barriers.

## Policies to Reduce the Cost of Credit

The thrust of these reforms has been to increase the efficiency of the banking system and reduce interest rates by lowering intermediation costs. The elements that underlie lending rates are:

- External dollar rate (U.S. treasury bill rate or the U.S. prime rate)
- Expected inflation, exchange rate policy, and country risk
- Bank risk, plus taxes
- Bank operating costs, profit margins, taxes, provisioning, capital adequacy, and reserve requirements
- Higher risk associated with lending to small borrowers

The first four elements provide the rate for large borrowers; and the last element gives the rate for small and medium size enterprise borrowers. Reforms to reduce lending rates involve bringing down the first four factors.

*Reserve Requirements*

Reduction of reserve requirements releases more funds to be intermediated and increases the profits of commercial banks. Beyond certain limits, reserve requirements are a tax on formal intermediation. Reserve requirements have been reduced and rationalized in the sample countries, although a complex system still prevails in Brazil. The greatest variation in reserve requirements is in Colombia, which uses them as the primary tool of monetary policy in spite of the availability of open market operations. Since 1990 required reserves have been increased in Colombia, leading to higher interest rates and reducing the benefits of eliminating directed credit.

*Increasing Competition and Efficiency*

To promote competition and efficiency, most countries have reduced barriers to entry and exit. Chile has accrued substantial gains in the form of reduced intermediation costs and expanded services from a competitive banking environment. Mexico, which currently has limits on entry, will need to enhance efficiency to compete with its NAFTA partners. Already there has been consolidation in the nonbanking sector in anticipation of greater competition resulting from NAFTA, but a strong nonbanking sector can emerge only after the commercial banks have strengthened their portfolios. Colombia has sold state participation in financial institutions to nonfinancial enterprises, but the concentration of ownership and control of financial resources, as well as the extended linkages between the financial sector and the productive sector, could become problematic. Some regulations have been introduced regarding lending to related parties. The liberalization of services under the Uruguay Round treaty could increase competition from foreign banks in all of the countries.

*Privatization*

In order to increase efficiency, the role of the public sector has been considerably downgraded, and public institutions have been restructured. A privatization program was activated in Colombia in 1990. Peru announced the privatization of state banks in 1991 (see chapter seven). Mexico, where the state was forced to take over banks during the debt crisis, initiated a reprivatization program during 1991 and 1992 and rationalized development banks and trust funds. State banks remain dominant in Brazil, Bolivia, and Uruguay, providing credit mainly to the rural and housing sectors.

## The Regulatory Environment

When Chile and Uruguay undertook initial reforms in the 1970s, they failed to improve their regulatory mechanisms. The other countries, which undertook reform during the 1980s and 1990s adopted comprehensive prudential regulatory and supervisory frameworks to preserve the solvency of the financial system. These were focused on capital adequacy of financial intermediaries, information disclosure, harmonization of accounting practices, and methods of dealing with financial distress. For instance, Mexico subjected its reformed banks to Basel Accord principles, requiring portfolio risk analyses and creating legal frameworks that set limits on the concentration of risk within and across financial groups. Bank portfolios remain weak, nevertheless, due to insufficient enforcement. Peruvian reform included es-

tablishment of an oversight program under which a bank found in violation of requirements by regulatory agencies has to prepare a remedial plan within seven days if it wishes to avoid intervention.

Many countries have implemented banking laws that set out regulations and remove preferential treatment of public sector banks. For example, Uruguay's 1992 Law of Financial Intermediation imposed reserve requirements on public banks for the first time. In addition, many countries have issued central bank charters that provide for improved mechanisms for monetary management and more independence from the government. Furthermore, many central banks have reduced the extent to which they also serve as development banks and trust funds. Additionally, open market operations have replaced reserve requirements (except in Colombia) as the primary source of monetary control and reserve management. Thus, institutional development has been important in enhancing efficiency in the financial sector.

## Other Policies

Factors outside the realm of the financial sector clearly affect the level of interest rates and, more generally, development of the financial sector. These include overall policy uncertainty, macroeconomic stability, and external effects. For example, Colombia has enjoyed relatively stable macroeconomic conditions, but the financial sector has failed to mature significantly, mainly because of overall policy uncertainty. Instability caused by fluctuations in the inflation rate and the exchange rate, as well as high fiscal deficits that crowd out private sector credit, have contributed to increased intermediation costs. Uruguay and Bolivia, which are significantly but not totally dollarized, are particularly vulnerable to large exchange rate fluctuations. Uruguay, whose economy is closely linked to those of neighboring Brazil and Argentina, is strongly affected by financial policies in these countries.

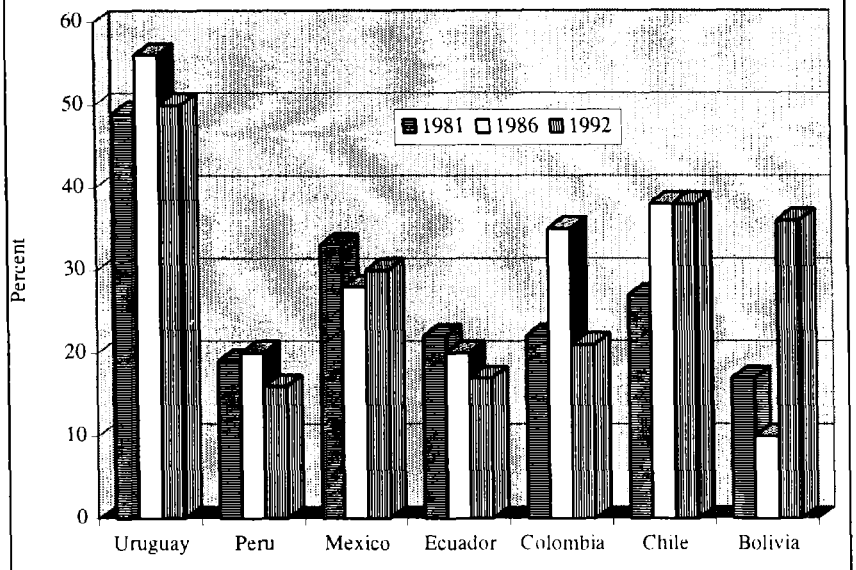
## The Results of Reform

In many cases, the financial sector reforms are too recent to permit definitive judgments regarding their long-term impact. Some highlights, however, emerge from preliminary survey of immediate results.

### *High Interest Rates*

Financial sector reforms have led to significant increases in real interest rates, with large spreads between lending and borrowing rates that imply continued inefficiency in the banking sector. The high cost of finance has been identified by the private sector as a major constraint on development in all

**Figure 6.2 Financial Depth (M2/GDP)**




*Source:* IMF, *International Financial Statistics*, various years

the countries examined. For example, in Mexico as of December 1993, the nominal interest rate for large prime bank borrowers was 17–22 percent, while small and medium-size borrowers typically were paying 27–37 percent. With inflation at about 8 percent, this implied very high real interest rates. Investment projects therefore must be very profitable to justify borrowing. The high rates have even led to proposals to revive subsidized credit programs. Resolution of macroeconomic factors (such as exchange rate stability) may reduce real lending rates by a few percentage points, but the high interest rates to be caused more by microeconomic considerations like bank risk, operating costs, and the excessive risks to banks of lending to small and medium-size borrowers, who remain unable to effectively collateralize loans. In January 1995, Mexican interest rates shot up over 85 percent per year to prime borrowers due to the macroeconomic crisis.

The increasing dollarization of Latin American economies suggests that high interest rates are not in fact a major burden for the private sector in general. Credit markets are segmented, and local currency operations are gradually being displaced by dollar-denominated operations for both deposits and loans, particularly in Uruguay and Bolivia. Customers who borrow on dollar-denominated terms appear to have better credit ratings than those who borrow in local currency. To facilitate intercountry comparisons, all local currency interest rates have been converted into

expost dollar equivalent rates by subtracting the rate of devaluation from the nominal interest rate.

In 1992 the average rate for dollar-denominated loans was only 13 percent for Bolivia, Chile, and Uruguay, while the equivalent dollar rate for peso borrowers was almost three times higher, at 34.5 percent. For prime customers in the dollar system, lending rates were as low as 8 percent in Uruguay. This is not substantially different from the U.S. prime rate (6.0 percent) and the Treasury Bill rate (3.4 percent), implying that credit is not that much more expensive in Latin America. However, the number of borrowers who have access to these rates may be limited. In addition, very weak local currencies add to the cost of intermediation, as evidenced by the spread between the local currency and the dollar lending rates. These spreads are far more significant than the borrowing spreads because they incorporate the low credit ratings of local currency borrowers.

Chile, Bolivia, and Uruguay, in particular, are experiencing a dollarization of their economies, and so the cost of credit should be calculated by using the costs of dollar credits weighted according to their share of total credit. The share of dollar-denominated credit in these countries is estimated to be around 75 percent, implying that the appropriate cost of credit is 9 percent in Chile, 22 percent in Bolivia, and 21 percent in Uruguay.

*Real Credit to the Private Sector*

The success of financial sector reforms is evident in the expansion of real credit to the private sector. The ratio of real private sector credit to total credit issued followed a familiar pattern: very high values in the early 1980s were succeeded by a significant drop in the mid–1980s and a renewal of credit to the private sector following reform. The cases of Bolivia and Mexico (through late 1994) clearly show how credit to the private sector has grown since reform.

**Table 6.3 Comparison of Local Currency and Dollar-Denominated Interest Rates**

| | Annual lending rates | | Annual deposit rates | |
|---|---|---|---|---|
| Country | Dollar equivalent rate on local currency loans | Dollar rate on dollar-denominated loans | Dollar equivalent rate on local currency deposits | Dollar rate on dollar-denominated deposits |
| Bolivia | 33.7 | 19.2 | 12.8 | 11.4 |
| Chile | 9.0 | 8.5 | 3.9 | 5.6 |
| Colombia | 20.2 | N/A | 11.1 | N/A |
| Mexico | 29.0 | N/A | 15.1 | N/A |
| Peru | 52.8 | N/A | 11.6 | N/A |
| Uruguay | 62.5 | 11.6 | 14.2 | 3.3 |
| **Average** | **34.5** | **13.03** | **7.6** | **7.01** |

*Source:* Rodriguez 1994.

*Financial Depth*

Financial depth reflects the stock of funds in the sector and is measured by the broad money supply (M2) as a percentage of GDP. Greater depth is associated generally with more developed and competitive financial markets, where inflation is likely to be lower and information is more easily acquired and transferred. All these factors contribute to lower lending spreads. As shown in figure 6.2, Uruguay has the greatest financial depth, but the ratio of M2 to GDP has declined since the mid–1980s. Bolivia has shown the most gain in terms of financial deepening from a very low base. Peru and Ecuador do not have much financial depth, reflecting the underdeveloped status of their financial sectors.

*The Spread of Financial Intermediation*

The financial margins of commercial banks in Latin America have been extremely high by international standards. For example, the ratio of net interest margins divided by total assets was 7.5 percent for Colombia; other developing countries had rates in the range of 2 to 5 percent in the 1980s, and industrial countries had rates between 1.5 and 3.2 percent. The spread between average real deposits rates and lending rates also remains high. In 1992 it amounted to 63 percent in Uruguay and 114 percent in Peru at the upper end, and 6 percent in Chile and 11 percent in Colombia at the lower end.

*The Impact on Savings and Investment*

Despite high interest rates, savings in Latin American countries remain low and are not sufficient to propel private sector development. Apart from the tenuous effects of real interest rate changes on savings, the reform process does not appear to have encouraged savings. Savings in our sample ranged from 7.2 percent of GDP in Bolivia to 24 percent in Chile. These rates compare poorly with savings rates of more than 30 percent of GDP in East Asian newly industrialized countries. Within this sample, Chile was the only country to steadily increase its savings rate since 1980, perhaps reflecting the extent and maturity of its reform program. In most of the other countries, there was a steady decline in the savings rate.

During the immediate postcrisis years (1982–87), total investment fell drastically to accommodate the sudden drying up of capital inflows. Public investment fell especially sharply. Although there has been a marked improvement in investment recently, only Bolivia and Chile have managed to increase their investment as a percentage of GDP beyond the levels of 1980. The ratio of fixed private investment as a percentage of GDP has steadily increased in Chile since the early 1980s, and Mexico and Uruguay have

shown considerable improvement since the mid–1980s. Bolivia, Colombia, and Peru have not been able to raise private investment (see figure 3.5).

## Lessons of Financial Reform

The diversity of experiences with financial reform among the eight countries provides an ideal framework from which to draw some broad lessons for future reformers and to identify challenges that countries already in the reform process must address.

A key component for successful reform is effective macroeconomic stabilization through fiscal discipline and prudent monetary policy. The reduction of fiscal deficits makes it possible to better manage inflation, interest rates, and expectations. In addition, effective strategies need to be developed to deal with domestic and external debt. Monetary policy should aim to maintain prudent monetary targets, to mitigate inflationary pressures, and yet to facilitate liquidity for financial intermediation.

The success of reforms also depends on a clear commitment to change on the part of the government, thus sending a message of policy certainty to the private sector. As a result of the generally unstable macroeconomic conditions under which reforms have been implemented, it appears that a credible, comprehensive, and rapid reform effort like that of Peru is more likely to succeed than a more gradual process. This view is corroborated by the experience of Ecuador, where early limited reforms in 1984 were followed by intermittent stabilization efforts and reversals. Having occupied a position of leadership in the early 1980s, Ecuador now lags significantly behind in bringing about policy changes. Another consideration is that the larger the magnitude of credible reforms, the more difficult it is to reverse the process.

Experience also suggests that initial financial liberalization, such as the deregulation of interest rates, the closing of development banks, the elimination of directed credit, and policies to enhance the efficiency of the banking system, need to be supplemented by an effective regulatory and supervisory framework that will foster development of the financial sector and maintain its solvency. Simultaneously, efforts must be made to promote the development of capital markets, increase the variety of financial instruments available, and mobilize long-term funds from institutional investors. Thus, institutional support and legal reform are complementary aspects of financial sector development.

Although most countries have made substantial strides in financial sector reform, they must consolidate their gains by ensuring that their financial systems do not slip back because of rising inflation and unstable macroeconomic environments. Continuous, effective macroeconomic policy, including exchange rate management, is crucial. High interest rates and privatization programs in many countries are exerting upward pressure on

exchange rates. Substantial positive differences between national and international interest rates (defined by the national deposit rate equivalent in dollars minus international dollar interest rates) have attracted capital inflows into the region, leading to appreciation of exchange rates and harming the export competitiveness of the private sector.

*Long-Term Financing*

Another issue that needs to be addressed is the lack of long-term financing for private projects. Due to high inflation, exchange rate risk, and political uncertainty, long-term financing has been scarce, with most loans and securities having a 90– to 180–day maturity. This has severely hampered private sector investment. This problem stems partly from the immaturity of the capital market and the limited availability of instruments that cater to private sector needs. Only Chile has been able to develop long-term indexed securities in the presence of high inflation. Mexico and Colombia have made some progress in developing medium- and long-term instruments. Because social security and insurance reform remain in their infancy, there is an absence of institutional investors as major players in the market and that has also reduced long-term financing initiatives.

The other dimension of long-term financing is the need for legal reform. Commercial banks fear being forced to reschedule bad loans as happened in the early 1980s, which has made them very cautious in lending. Small and medium-size enterprises suffer most. In most countries in Latin America, the legal system stifles development of this sector by requiring that a specified amount of equipment be exempt from debt-collection procedures, as well as having cumbersome procedures for creditors seeking to enforce claims against collateral. In Bolivia all steps in the collection process (the right to collect, to repossess, and to sell) must be taken through the court system separately. Reforming the laws governing secured transactions will greatly facilitate the development of financial markets in the region.

In the context of low savings rates and only moderate growth, it is unlikely that domestic savings will significantly increase in the short to medium term to provide funds for private sector financing. Thus, the encouragement of foreign investment and the opening of capital markets is important for fostering private sector development.

The agenda of financial reforms therefore should focus on increasing bank efficiency and extending the reform process to the development of the capital market, with an eye to expanding the variety of financial instruments and lengthening their maturities. This, combined with continued macroeconomic stability and legal reform, should stimulate private sector development.

*Financing of Infrastructure in the Future*

The sheer magnitude of future infrastructure investment requirements will severely test the ability of financial markets in Latin America to intermediate funds, both from within the region and from outside. Annual infrastructure investment needs for Latin America have been estimated at $60 billion, or 5 percent of GDP. At least part of this amount will have to be financed by the private sector because governments attempting fiscal control will be unable to invest as much as necessary. In Mexico, for example, there was no private sector contribution to infrastructure until 1989. From 1989 to 1992 private sector investment (all in transportation) grew from 2.5 percent of total investment to almost 70 percent. During the same period, total infrastructure investment increased 160 percent, compared with a 12 percent decrease during the three previous years. The future investment requirement of 5 percent quoted above may prove difficult to achieve, as it is well above the 3 percent invested in Latin American infrastructure during the 1980s and even higher than the 4 percent invested during the "boom" time of the 1970s. Certainly, without significant private sector assistance it will be difficult to attain.

There are various problems involved in obtaining the necessary amount of private sector participation in infrastructure:

- Infrastructure projects tend to require large one-time investments that take decades to pay off. Although foreign private sector companies may be able to raise that sort of capital, Latin America has few long-term capital markets that are willing or able to make such loans.
- Investors will want high returns to mitigate the risks of infrastructure investment. These risks are the results of demand fluctuations, inconsistent tariff levels, and unstable government policies, among other things.
- In order to encourage private sector participation, governments need to address these problems. Some plausible solutions include:

- *Allowing insurance companies, mutual funds, and pension funds to invest in the projects.* The lack of long-term loans has limited the development of the private sector in Latin America in many ways, and the large financial holdings of the funds appear an ideal solution. They all have long-term liabilities and, therefore, would prefer to balance their liabilities with long-term assets such as the returns from infrastructure projects. Chilean pension funds recently received permission to invest abroad because they had exhausted the domestic opportunities. Brazilian pension and social security systems are also looking to invest their $20 billion in long-term assets in national projects.

- *Rationalizing tariff rates.* Transparent rates will serve the dual purpose of facilitating risk and return estimates for potential investors and of stimulating demand for the product. An additional benefit, especially for electricity and telephone services is that, if constant rates can be maintained across customers in place of the current subsidies for rural or poor consumers, then service providers would no longer have any incentive to avoid those customers. The state-owned Chilean water company fixed its maximum rates for a period of five years based on the replacement value of existing installations. The government anticipates that the tariffs will cover the total investment cost as well as eliminating cross-subsidies.

The funds required to improve infrastructure systems in Latin America are available if only the governments can create favorable investment conditions. As it is unlikely that governments will finance such projects on their own, pension and mutual funds should be allowed to buy stock in the systems, unstable government policies should not be allowed to interfere with private sector profit and risk estimates, and transparent rate structures should be facilitated to allow the systems to provide services in the most efficient manner.

# 7
# Privatization

The goal of privatization, stated simply, is to increase the role of the private sector in the economy, thereby promoting a more efficient use of resources and providing a strong signal that policies introduced to promote market-based reforms will not be reversed. Alternatively, privatization can be viewed as putting more resources at the disposal of the private sector, thereby promoting efficiency and growth. Studies of privatization confirm that private ownership appears to be a powerful means of raising efficiency, reducing the government's fiscal burden, and creating an environment for growth. Studies of the efficiency of firms before and after privatization show that in nearly all cases transferring ownership from the state to private hands raises productivity. Walters (1990) suggests, in addition, that as privatization gathers steam, state-owned enterprises (SOEs) not yet sold substantially improve efficiency to increase their marketability; the prospect of competing with the private sector appears to concentrate the minds of the managers on enhancing productivity.

There have been strong privatization efforts in the developing world since the 1980s, with Latin America leading the way. Privatization in Latin America has helped the transition from debt financing in the early 1980s to a diversification of investment financing in the 1990s. The eight countries considered here includes some, like Chile and Mexico, that have privatized rapidly in diverse sectors, as well as countries like Ecuador and Uruguay that have moved slowly in limited spheres of public sector activities. This chapter examines the privatization experience of the eight countries, identifies the issues that are important for privatization, and draws lessons for other countries.

## Background

The public sector began to assume an increasing economic role in Latin America in the 1950s. Structuralist ideology, combined with the import substitution strategy of industrial development, was the force behind the ex-

pansion of the public sector in these countries. State-owned enterprises were established in sectors that were considered to provide strategically important public goods or in sectors that were viewed as being important to the national interest. In practice, however, the economic objectives of SOEs were eventually replaced by short-term political goals. These enterprises became large employers and suppliers of highly subsidized goods and services to the public. SOEs turned out to be grossly inefficient, which increased costs, especially in the provision of infrastructure services. The provision of subsidized goods and services to the public became an increasing financial burden, because many SOEs incurred substantial losses, draining resources from the government budget as well as the domestic financial markets. Meanwhile, the subsidies, many of which were captured by the middle class, created distortions in resource allocation.

The growth of SOEs was accompanied by substantial regulation restricting the freedom of the private sector. The government controlled entry and exit into certain industries, regulated prices and quantities, subjected the creation of new firms to significant red tape, and enacted labor legislation that diminished the flexibility of the labor market.

The generally disappointing performance of the SOEs—which in part contributed to the debt crisis—made privatizing them an attractive option for many developing countries. Privatizing has come to be viewed as a strategy to increase efficiency and productivity growth as well as to generate new investment. It has been aimed at eliminating the soft budget constraints for these enterprises and subjecting them to greater market discipline. Privatization has also been expected to ease the budgetary pressures on governments by eliminating subsidies and transfer payments, and by generating revenues and foreign exchange through the sale of assets.

For this group of eight countries, privatization has been an important part of a more extensive program of economic liberalization, including fiscal and monetary reforms, trade and payments reforms, financial sector

**Table 7.1 Privatization in Latin America in Selected Countries**

| Country | Enterprises Privatized | Percent of GDP | Privatization Income (million US$) |
|---|---|---|---|
| Argentina | 84 | 5.3 (1992) | 12,135 |
| Brazil I | 38 | 0.2 (1990) | 824 |
| Brazil II | 22 | 1.4 (1992) | 6,648 |
| Chile I | 325 | 7.0 (1994) | 952 |
| Chile II | 207 | 6.1 (1994) | 1,349 |
| Mexico | 930 | 6.4 (1992) | 21,247 |
| Peru | 41 | 10.8 (1993) | 2,622 |

*Source:* D. Hachette and R. Luders 1994

reforms, and labor market reforms. Like the reform programs themselves, the record of privatization in these eight countries has been varied, as table 7.1 indicates. The deepest privatizations have been in Chile and Peru. Chile has privatized the equivalent of more than 13 percent of GDP, in two phases over an extended period, and in Peru, the equivalent of nearly 11 percent of GDP has been sold off in a short space of time. Taking into account the firms that have been scheduled to be sold, the privatization program in Peru is probably the most radical recorded anywhere, and it has demonstrated the strong commitment of the government to its economic reform program. Privatization has also been extensive in Argentina and Mexico. In the latter, however, some sectors have been declared "strategic." It is interesting to note investor response to the policy programs announced in the wake of the crisis at the end of 1994. Mexico's failure to privatize more extensively was viewed by many commentators as undermining the credibility of the measures that were announced; Argentina's announcement that virtually all enterprises remaining in the hands of the state would be sold was cited as being a major factor in the decision of foreign banks to continue to lend. Bolivia, Ecuador, and Uruguay have moved rather slowly in selling off SOEs. Uruguay's plans to privatize its telecommunication company were defeated in a national plebiscite in December 1992. By contrast, the privatization efforts of Colombia, and Brazil have gathered momentum.

## Analytical Issues

The premise of privatization is that the change of ownership enhances efficiency and improves performance. Therefore the central issue is whether "ownership" is an important determinant of economic performance. Economic theory posits a link between ownership and performance based on differences in incentives between public and private organizations that arise from the ability of owners to monitor managers. In public sector organizations, politicians and state bureaucrats are more likely to pursue their own self-interest rather than the public interest or the will of the people. Policies are arranged to maximize votes and to expand departmental budgets so that bureaucrats benefit from better jobs and higher salaries. The information gap between bureaucrats and taxpayers about the consequences of budgetary changes also inhibits public monitoring of spending and provides an opportunity for public sector trade unions to inflate wage demands and protect overstaffing. In the absence of a private profit motive, government entities therefore tend to pursue goals such as budget maximization, risk aversion, overstaffing, and nonoptimal pricing, employment, and investment.

Given these considerations, analyzing the effects of privatization requires a framework that combines the elements of ownership, market structure, and market forces that determine a firm's performance (see Hartley

and Parker 1991). Such a framework implies that maximum efficiency is obtained by control over the firm by the owners, market rivalry, and profit maximization. At the other end of the spectrum is the case of a public sector monopoly subject to minimum control and pursuing multiple objectives that ultimately lead to departures from the allocative optimum. From the perspective of efficiency, the former type of firm is clearly superior to the latter.

## Restructuring and Privatization

In the context of privatization, it is useful to distinguish between financial, legal, and organizational restructuring, on the one hand, and physical restructuring—fresh investment in rehabilitation, modernization, or expansion—on the other. While the first three types of restructuring may need to be undertaken before a firm can be privatized, the latter type is best left to the future owners (see Kikeri, Nellis, and Shirley 1992). For instance, buyers are unlikely to accept a firm with large accumulated debt. Similarly, such issues as inadequate title and legal structures that make it difficult for private investors to buy shares in public enterprises must be dealt with before privatization. In addition, labor issues such as overstaffing or seriously flawed labor agreements may have to be resolved before privatization to prevent the prices paid from being highly discounted.

For example, in the second round of Chilean privatization, after 1981, the government passed legislation to transform the SOEs into corporations whose shares could be traded on the stock exchange and whose accounts and operations would be subject to audits by the Superintendency of Securities and Insurance. Thereafter, divestitures were carried out gradually by issuing shares to as many purchasers as possible.

Likewise, the legal framework in Peru was modified in September 1991 to accommodate four different potential approaches to privatization—direct sale, minority share offers to national or foreign investors, participation and service agreements, and termination of activities and operations—and to establish new procedures corresponding to each.

### *Political Issues*

In the initial stages, privatization efforts can run into serious political opposition from groups that have benefited from overregulation and a large public sector, including SOE unions, bureaucrats, and some private agents who have been able to control regulators. This was true in Chile and Peru, but political opposition was minimal in Mexico, where the program was designed in close consultation with labor unions and the private sector.

In Colombia, although the level of state intervention has been lower than other Latin American countries, privatization has not been a major

**Box 7.1 Monopolies in Industrial Inputs in Peru**

The extent to which competitive conditions obtain in a given industry is difficult to measure from published statistics. The market power that dominant firms enjoy depends not only on their size relative to a well-defined market, but also on the extent to which imports can freely contest the market. A 1990 survey on the extent of monopoly conditions in Peru before structural reforms took effect provides a somber picture for certain sectors.

In the pulp and paper industry, a state-owned enterprise, Paramonga, produced 60 percent of the national market for writing paper, more than 80 percent for wrapping paper, and 80 percent for cardboard. Import tariffs on competing goods were high, and the Ministry of Industry would approve requests in these areas only if Paramonga could not supply. Peruvian-produced goods were of poor quality and were priced (in 1988) at two to three times world prices. These quality and price problems penalized exporters seeking to buy packaging (for frozen fish, for example).

Only one Peruvian firm, SIDERPERU—another state enterprise—produced basic steel, and it did this largely with inputs purchased from a state-owned mining company. It was Peru's only integrated producer, and at any stage of production it had little competition. Under a 1986 law, SIDERPERU enjoyed duty-free imports and tax-free electricity. It also received export subsidies. Almost all imports of steel and tin plates required a prior license from the Ministry of Industry. The poor quality of SIDERPERU's tin plate cause problems for exporters. It is small wonder that, in 1982, SIDERPERU successfully led the battle to increase protection levels after the government liberalized imports.

Seventy-nine percent of capacity to produce basic chemicals was accounted for by public firms or those of mixed ownership. Most was in the hands of four state firms. According to the firms interviewed in the 1990 survey, Paramonga had a de facto monopoly of the import and production of PVC and charged twice the international price. Petrochemicals were in short supply, but private firms linked to employees of Petroperu reportedly cleared the market by being able to sell the same items at higher prices. In addition, there was a de facto monopoly in caustic soda and sulfuric acid.

By 1991, the monopoly these firms had enjoyed had come to an end. Imports were liberally permitted, tariffs were low, and all the firms were listed for privatization. In that year, SIDERPERU tried to repeat its success of 1982 in increasing protection, but this time it failed.

priority. The slow pace and narrow scope of privatization are the result of opposition from labor unions and, more generally, lack of broadly-based public support. Early difficulties also proved to be a major setback in fostering favorable public opinion about the program.

Although Bolivia's successful adjustment program begun in 1985 sought to reduce and redefine the role of the public sector, the government

failed to secure the necessary political support to carry out the program. Even though a new privatization law was enacted in April 1992, charges of corruption within the government, lack of interest among investors, and opposition from the Bolivian Central Workers Union and the military contributed to the slow progress of privatization. Serious political commitment to privatization was also absent in Ecuador; the Consejo Nacional de Modernizacion del Estado was set up in November 1992 to oversee the privatization program, but no one was appointed to manage it until April 1994. The current administration still fundamentally believes strongly in state participation in the economy and has consequently been reluctant to introduce a large-scale privatization program. In Uruguay the privatization program has been impeded by heavy public opposition; nearly 10 percent of Uruguay's labor force is employed in the public sector and actively resists the notion of privatization.

In most of these eight countries, privatization gathered political support only slowly, typically through schemes that distributed a percentage of the shares in privatized firms to the workers, usually at a low price. Improvements in the quality of services provided by privatized firms have led to consumer support for later rounds of privatization.

*Regulatory Issues*

A key challenge of the postprivatization era in these countries has been the design of an appropriate regulatory framework for increasing the involvement of the private sector in activities that were once reserved for SOEs. It is necessary to distinguish between sectors that can be self-regulated—those characterized by open competition or at least contestability—and those that require active government regulation, such as natural monopolies. While most privatized firms belong to the former category, a small but important group of industries, including utilities and the financial sector, usually work better when subject to a modern regulatory framework.

A related issue is that of promoting and maintaining effective competition where a monopoly existed in related activities. The Telephone Company of Chile (CTC) was a natural monopoly in its local networks but was subject to competition in long-distance service. Transmission and distribution of electric power have characteristics of a natural monopoly, while generation is competitive. In this situation, there are two measures that can safeguard competition: vertical separation, that is, separating one activity from the other (for example, separating generation from transmission and distribution); and interconnection—the regulation of the price at which firms in the competitive subsector obtain their inputs from the natural monopoly. Both measures were adopted in the case of CTC (see Hachette and Luders 1993).

One way to regulate a potential monopoly is through franchising

or competitive auction. If successful, this approach stimulates competition and efficiency and destroys undesirable monopolies on information. The franchising option was used successfully in Chile. To encourage competition in the electricity sector—a virtual public monopoly before its divestiture—the Chilean authorities also used the principle of yardstick competition, under which, in the presence of information asymmetries and when a principal has many agents under control, the optimal incentive scheme involves making the rewards of each agent contingent upon the performance of other agents as well as his own. Thus, the price that one agent can charge depends on the costs incurred by others. These measures in turn lead to allocative and internal efficiency. In contrast, Mexico neglected to strengthen its regulatory agency responsible for telecommunications until after privatization.

*Sequencing*

How and where does privatization fit into the overall sequence of other economic reforms? On the basis on Chile's experience in the 1970s, some commentators have argued that financial sector reforms should come near the end of the reform process (see, for example, McKinnon 1991). The overall failure of the financial sector reforms in the Southern Cone countries in the 1970s have also illustrated the need for a modern supervisory framework before banks are privatized (see chapter six). It could even be argued that, once the regulatory framework is in place, privatization of banks should take place during the early stages of the reform process. In a majority of the eight countries considered here, privatization has often been the centerpiece of an overall reform of the economy.

*Methods of Privatization*

The experiences of these eight countries reveal a wide variety of methods for privatization:

- Sale of a controlling percentage of shares to a private company or consortium
- Gradual sale of the firm, which reduces the risk of underpricing
- Initial public offerings of shares on a stock exchange, either domestic or international
- Employee buyouts
- Liquidation of firms and the sale of their assets
- Lease and management contracts
- Use of private financing and management (rather than public) for new infrastructure development

- Outsourcing the contracting of traditional public sector functions and public services previously provided by SOEs to private vendors.

Different methods might be used depending on the goals of the privatization program. For example, the sale of a controlling interest speeds the process and raises revenues in the short run. Public offerings help to spread share ownership. In particular, international offerings can signal the government's commitment to privatization and increase the global standing of the issuing firms. Employee buyouts have been instrumental in reducing an important source of opposition to privatization.

Infrastructure privatization often has been motivated by a desire to tap new sources of funds to supplement the constrained resources of the public sector. In addition, infrastructure privatization can be supported by user fees, so that financing can be obtained without an overt increase in taxes, thereby taking an activity off the political agenda. Privatization thus has particular appeal when the public sector faces considerable taxpayer resistance and when it has been unable expeditiously to finance badly needed facilities or activities that the private sector might undertake for a profit.

The private provision of infrastructure and outsourcing could be viewed as the final frontier of privatization in these countries. Although there have been some initiatives in Mexico and Uruguay for private provision of infrastructure and outsourcing, they really represent future avenues for privatization. Among the many activities that are potential targets for such privatizations are waste disposal, transit operations, school lunches, sewage and water treatment, airports and airlines, and prisons.

It is illustrative to look at the privatization methods used in Chile, the country with the most extensive experience in our sample. In the first round of privatization, from 1974 to 1981, Chilean authorities offered controlling-share packages at auction and granted credit purchases. The primary objective of the auctions was to maximize the sale price of public sector assets. In addition to auctions, liquidation and direct sales also were adopted. Direct sales usually involved smaller enterprises, for which the cost of organizing a bidding process was high relative to the expected sale price. It was also used when the government anticipated only one bidder or when the bidding process had not yielded minimum acceptable prices.

The privatization methods used in the second round of Chilean privatization after 1981 reflected the new objective of distributing ownership rather than maximizing revenues. As before, the controlling stock was offered as a package, but unlike the "debt-led" first round, no credit was granted and bidders were obliged to prove their solvency. In the second round, shares were offered to workers, institutional investors, and individual investors to ensure as wide a distribution as possible.

In Mexico, a six-member privatization unit in the Ministry of Fi-

nance has administrative responsibility for selling SOEs. The unit was created in 1988 and headed by a coordinator-general. The privatization process was streamlined and made transparent through guidelines that clarified the roles of the various agencies involved. Actual management of sales was done by an agent bank, appointed and supervised by the unit and paid 1 percent of the sale price as commission. This was done to ensure that the divestitures were carried out as arm's length market transactions. Sales were by sealed-bid, first-price auction. Bidders were prescreened as to their technical, managerial, and financial capabilities, after which the agent bank examined and standardized the bids. Although the bidders' plans for the company—investment programs and labor policies for example—were taken into account, the primary criterion was price. It is also interesting to note that Mexico began the privatization process by selling medium-size enterprises so that if difficulties did arise, they could be resolved before large-scale privatization was undertaken.

*The Role of Foreigners*

Foreign investors have participated in privatizations in these eight countries through direct investment as well as through portfolio equity investment. In the latter, the foreign buyer engages in a purely financial investment, with the individual share usually not exceeding 10 percent. In the case of foreign direct investment (FDI), this share exceeds 10 percent and the investor is usually interested in controlling the operations of the firm (Sader 1993).

Portfolio investments are typically carried out by purchasing equity instruments traded in international security markets. The most commonly used instruments are the so-called American Depository Receipts (ADRs) and Global Depository Receipts (GDRs). ADRs are negotiable, equity-based instruments publicly traded in the U.S. securities markets. They are especially popular with U.S. institutional investors who are legally limited as to the extent of their direct liability in foreign stocks. GDRs are similar, with the additional feature that they can be traded simultaneously in securities exchanges around the world.

These instruments have been used extensively in the sale of the large telecommunications companies in these countries. In July 1990, Chile became the first country to use ADRs in July 1990 for the sale of the remaining part of Telefonos de Chile. ADRs worth $98 million were offered on the New York Stock Exchange—the first international equity offering by a Latin American country in twenty-five years. The largest single issue of ADRs was carried out by Mexico in May 1991, when the remaining 15 percent of Telefonos de Mexico (TELMEX) were privatized for $2.4 billion. A year later, TELMEX offered another $1.2 billion in ADRs. In addition, Mexico issued GDRs worth $638 million in 1991 for the privatization of its largest bank, Bancomer, which sold for $2.5 billion.

Privatization leads directly to foreign direct investment through the sale of assets to foreign investors, but it also has indirect effects. It improves the regulatory environment for other foreign investors and leads to better returns on investment by reducing market distortions and by transferring SOEs to the private sector. This second effect is especially relevant in sectors that provide services crucial for the profitability of other sectors in the economy, including infrastructure services such as energy, telecommunications, and transportation[1].

The existence of a substantial privatization program that is relatively accessible to foreigners has been an important vehicle for attracting additional FDI inflows in many Latin American countries, including Chile, Mexico, and Peru. In Brazil, however, foreign investors have been virtually absent from the privatization process, presumably because of restrictions on foreign share ownership (foreigners cannot acquire a share larger than 40 percent except through direct congressional authorization), continued uncertainties in the macroeconomic and political climate, and legal restrictions on repatriation of earnings.

To summarize, privatizations attract additional investment by enhancing the efficiency and profitability of the economic environment. In addition, an improved infrastructure, combined with liberal financial markets and increased fiscal credibility, reduces overhead costs for entrepreneurs and facilitates the successful management of private ventures.

*Social Security Systems*

Many Latin American countries have begun privatizing their social security systems. Starting with Chile's pioneering efforts in the early 1980s, social security reform has been undertaken by Argentina, Mexico, and Peru. The social security reforms in these countries have two main objectives: (a) to replace the financially troubled, pay-as-you-go pension schemes with fully funded capitalization systems based on individual retirement accounts; and (b) to develop a large presence for institutional investors in emerging capital markets. Privately administered pension funds also open new channels for privatization. For instance, in the second round of privatization in Chile in the 1980s, pension funds were given an opportunity to buy shares at subsidized prices, which helped spread ownership. Reform of the social security system will be required if economic reform is to succeed in Uruguay.

1. On the basis of privatization experience from a cross-section of twenty-one countries during 1988–92, Sader (1993) found that the privatization of SOEs which provide infrastructure services has a strong effect on investor perceptions

*The Proceeds*

The bulk of the proceeds from privatization in these countries has gone toward reducing public debt. In Mexico all the proceeds from privatization have been used to repurchase internal debt, and the savings from reduced interest payments have been used to finance poverty-alleviation programs. In Brazil the privatization proceeds have been used principally to reduce federal public debt, although some have been also used for social programs. In Colombia more than half of the proceeds have been used for external debt prepayments and overdue pension payments; the remainder have been used for financial rehabilitation and to replenish a guarantee fund for financial institutions.

## Winners and Losers

One way to characterize the outcome of the privatization experience in these eight countries would be to classify the various stakeholders in the process as winners or losers (see Galal and others 1994). Workers were never losers and were sometimes winners. When compensation payments are taken into account, divestiture never made workers of the divested firms worse off. As participants in the equity of the divested firms, workers made substantial gains in the case of Mexico's TELMEX and Chile's electricity distribution company ENERSIS. Consumers were often but not always winners. Consumers of telecommunications services in Mexico now pay higher prices because tariffs were previously too low to cover costs and allow for expansion. ENERSIS of Chile is a special case: after divestiture, the company reduced the theft of electricity significantly, which hurt those who had been getting free power but allowed lower prices for paying consumers.

Foreigners did well, but so did nationals. In general, foreign investors profited, as in the case of Mexico's TELMEX and Chile's CTC, but not with Mexicana Airlines. Buyers—for instance, the pension fund shareholders in Chile—benefited in almost all instances, except in the case of Mexicana Airlines. In the majority of cases, the divesting government did well, receiving more in sale proceeds and the discounted stream of taxes than it would have received in dividends and taxes had public ownership continued. In two instances in Chile, however, the government lost small amounts.

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of the country and attracts additional FDI inflows. Privatizations in other sectors of the economy usually do not have this effect, except in the primary sector (agribusiness, hydrocarbons, mining, and the like).

## Results

Case studies of privatization in the sample countries point to a number of benefits from privatization (see Galal and others 1994).

- Higher investment. This is especially the case where public enterprises had left demand unmet because of tight budgets. A striking example is Chile, where the telephone company (CTC) doubled its capacity in the four years after divestiture.
- Improved productivity, improved labor-management relations, better incentives, and internal reorganizations. In the case of Mexico's TELMEX, total factor productivity increased more than 15 percent in 1991 alone. Improved productivity also has come from diversification of firms into activities previously unexplored; public enterprise managers either had no incentive to pursue such activities or were blocked by bureaucratic restraints from doing so. Chile's CTC now provides a wide range of new value added services. In at least three of the four privatizations in Colombia—an automobile assembly plant, a large refuse collection company, and a bank—productivity and efficiency improved. In Chile the efficiency advantage of privatized firms has been found to be statistically significant, although somewhat small (Hachette and Luders 1993).
- Stronger competitive forces. In Chile and Mexico private airlines were granted free entry into a domestic market that had been limited to one or two enterprises.
- Expansion and modernization of capital markets. In Chile the number of shareholders in the economy has risen from 26,600 in 1985 to more than 200,000 in 1992. The restoration of Chile's credit rating to investment grade BBB by Standard and Poors in August 1992 also helped Chilean firms gain access to cheaper credit (Chile thus became the first Latin American country to regain an investment grade rating.) Domestic pension funds in Chile, which were authorized to purchase shares in 1987, have emerged as a significant source of capital.
- Generation of public revenue. In almost all instances, successful privatizations have achieved their short-term goal of generating public revenue from SOE sales and of reducing the fiscal drain from financing SOE losses (see Kikeri, Nellis, and Shirley 1992). In broader sense, privatization has helped governments to shift their energies from the public production of goods and services to provision of an enabling environment for private sector development in general and to issues such as monopoly regulation and social programs in particular.

## Lessons of Privatization

This review of the privatization experience of eight countries offers several lessons for countries that are embarking on the privatization process. Privatization works best when it is part of a larger program of reforms to promote efficiency. In addition, strong political commitment is a necessary condition for the success of privatization as the cases of Chile, Mexico, and Peru illustrate. The slow progress of privatization in the remaining five countries—Bolivia, Brazil, Colombia, Mexico, and Uruguay, is in part due to insufficient political support.

Good regulation is critical to the successful privatization of natural monopolies: it provides producers with incentives to reduce their costs and with a stable environment in which to expand and, simultaneously, safeguards against potential exploitation of consumers. It is also important to resolve constitutional and other legal impediments to privatization at the outset.

Countries can benefit from privatization of management without privatization of the ownership of assets. This has turned out to be especially relevant in the embryonic cases of private provision of public services, that is privatization of infrastructure and outsourcing.

The sale of large enterprises requires considerable preparation. It is important to break down large enterprises into competitive and marketable units and to ensure that the necessary resources have been spent on management consultants and lawyers for preparation of the sale. It may be prudent to begin the privatization process with the sale of medium-size enterprises, so that if problems arise they can be resolved before large-scale privatization is attempted, as was done in Mexico.

Transparency is critical for the economic and political success of the privatization process. Mexico made the sale of enterprises transparent by adopting competitive bidding procedures, developing objective criteria for detecting bids, and creating a clear focal point with minimal bureaucracy to monitor the overall program.

Promotion of investor interest is important for generating multiple bidders, both foreign and domestic, improving the government's bargaining position, and dispelling notions that SOEs are being given away. Spreading share ownership was in fact the paramount objective of the second round of privatization undertaken in Chile after 1981. The dispersion of share ownership also helps to reduce political opposition, especially when large "strategic" SOEs are involved.

The government could divest some ownership, if full divestiture cannot be accomplished at once. This is especially relevant to countries with low administrative capacity, an underdeveloped private sector, and a lack of transparency in the privatization process.

The most important factors in unsuccessful privatizations appear

to be legal impediments to privatization and the lack of a clear regulatory framework. Other factors include political opposition from interest groups, conflicting objectives, suspicions of impropriety in the sale process, and poor preparation of the sale.

The final lesson is that the government should make the objectives of the privatization effort clear and should rank them in order of priority.

# 8
# Institutions and Property Rights

Economic growth stems from four sources: the traditional Solow process of *capital deepening*, which implies higher capital stock, whether human or physical; the processes of *commercial expansion and greater specialization*, first described by Adam Smith; *population growth*, which is associated with economies of scale, in particular the more intensive use of fixed capital stock; and increases in the stock of *human knowledge*, whether a diffusion of existing technology or the introduction of new technology. The last of these, often described as Schumpeterian growth, involves "....any change in the application of information to the production process resulting either in the production of a given output with fewer resources (lower costs) or the production of better or new products." (Mokyr 1990, p. 41)

Taking advantage of any of these sources of growth involves increased risk, either because of the need to finance investment or because they involve complicated contractual relationships among savers, investors, producers, distributors and customers. The process of growth therefore requires improved risk management. The risks of doing business in a modern industrial economy are vastly greater than in a barter economy. The evolution of institutions that promote better ways of dealing with risk has been neglected in most of the literature on economic development, which has traditionally focused on the macroeconomic environment and incentive policies or on attempting to isolate policies that promote growth. Even after reforms had been implemented in these two areas, disappointing growth performance in many countries has led to a recognition that institutional factors have important effects on the business environment. If public institutions do not work and political conditions are too unstable, the risks of entering into contracts rise and private sector investment decreases.

Institutions must therefore provide the foundation for economic development. They should assist in risk management by minimizing transaction costs, allowing secure contracts to be written, and ensuring the sta-

bility of property rights. Specifically, markets will operate most efficiently when institutions foster:

- Low transaction costs
- Efficient conditions for raising capital
- A clear definition of property rights
- Freedom to contract without fear of government interference
- Efficient enforcement of contracts
- Clear rules governing commercial transactions
- Equal administration of rules of law in civil disputes
- Security in the possession of assets
- Stability in the structure of relative prices

The institutional structure includes the formal and informal rules that govern the behavior of economic agents. It determines the degree to which contracts can be entered into without undue interference, the extent to which contracts can be enforced, the security of property rights, and the overall cost of business transactions. At the national level the most obvious institution is the legal system, which consists of a hierarchy of formal rules—from the constitution to local laws and individual contracts—that define the form of and constraints on contracting. Economic rules determine (indeed, are synonymous with) property rights, which in turn define the conditions of ownership and the nature of the transfer of goods and services. In addition, there must be an effective enforcement mechanism. In the case of formal institutions, this implies that the state must be a coercive force in protecting property rights and enforcing contracts."A government that credibly commits itself to upholding rights of property and contract enforcement not only provides a basis whereby partners in economic transactions can trust each other; it also reinforces the hope that the government itself can be trusted to transact honorably and to meet its contractual obligations" (Orr and Ulen 1993, p. 3).

## Transaction Costs

Traditional analysis assumes that transactions take place without cost and that information is freely available. Clearly, this is a major departure from reality, but it was thought to be the basis on which to build valid conclusions without significant compromise. However, Coase (1960) has shown that transaction costs frequently determine the nature and organization of economic activity and that they significantly influence the distribution of income. Transaction costs comprise the costs of arranging, monitoring, and

fulfilling contracts—contracts being understood broadly as the arrangements necessary for any economic exchange, whether occurring in markets between unrelated individuals or within the "hierarchy" of a firm. Once transaction costs are taken into account, the crucial importance of the legal system in economic processes is highlighted.[1]

*Property Rights*

Property rights are those rules and enforcement mechanisms that determine the ownership and means of transfer of factors of production, goods, and services. For property rights to be efficient, they must be universal, exclusive, and transferable. All resources should have an owner, except when efficiency is not an issue. Use of a resource is restricted to the owner, and only a buyer and seller can approve the conditions under which a transfer of ownership takes place. If a third party interferes with this contract, it is invalidated. For example, if the government imposes price controls, the property rights of those who have become subject to such price controls are, in a strict sense, violated.

The absence of well-established private property rights will prevent people from enjoying many of the benefits of markets. The difficulties experienced in countries that have no well-defined property rights—for example, the former Soviet Union—clearly illustrate this point. It is also clear that high costs for determining private property rights may lead to market failures. As long as property rights are clearly defined, free markets can generate the highest level of economic welfare. It should be expected, therefore, that those societies in which property is privately owned and free markets are well developed will be more prosperous than those in which private property does not exist or is subject to institutional uncertainties. It is precisely in their effects on economic growth that the importance of property rights can be best appreciated.

Security of property can be threatened in several ways. The state can confiscate the property or fail to enforce the owners' rights when they are encroached on by a third party. Property rights also can be undermined indirectly through regulations that inhibit the owners' rights to use their property as they desire or through rules governing whom property owners

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1. Ronald Coase analyzed the importance of transaction costs and property rights in two pathbreaking articles, (1937, 1960). The relationship between these two factors has frequently been overlooked. In particular, the second article, "The Problem of Social Cost," has been taken to indicate that from society's point of view, the initial allocation of resources is irrelevant. However, Coase has recently emphasized (1990, p. 6) that because of transaction costs, the initial allocation of property rights is crucial in determining the allocation of resources.

may employ in seeking to use their property. Unstable institutions also reduce the security of property rights."Contracts with, or assurances of property protection from, a politician in power are not a close substitute for a long standing and visible tradition of honoring the contracts...according to well-understood rules." (Orr and Ulen 1993, p. 14)

Since economic growth involves more specialized activities, it also requires larger markets and longer-term processes and contracts. If private property rights are insecure, because they are either weakly defined or difficult to enforce, incentives for private investment and savings will be reduced, with corresponding negative effects on growth rates. In general, inefficiencies multiply when resources are allocated by fiat rather than through market mechanisms.

If private entrepreneurs can bribe politicians and bureaucrats (which is not unknown in Latin American countries or elsewhere), some of the negative effects of the political control of assets can be undone, thereby enhancing efficiency. However, using corruption as a mechanism for restoring productivity creates problems. First, asymmetric information between the bureaucrat and the entrepreneur may prevent an efficient bargain from being struck. Second, after paying bribes, the entrepreneur might be too poor to invest in his business (especially if capital markets are imperfect). Third, if entrepreneurs must collectively bribe bureaucrats to rescind some rule that hurts them all, a free-rider situation may develop—in which each has an incentive to see the problem corrected only at others' expense, preventing them from taking action together. To some extent, all these problems reduce the effectiveness of corruption as a method of enhancing efficiency. In addition, since contracts based on bribery will not stand up in court, neither party has any credible recourse should the contract be broken (see Shleifer 1994).

## Property Rights in Latin America

Carvalho (1994) maintains that Latin Americans have been trading freedom and property rights for state protection since the time of the wars for independence in the nineteenth century. With remarkably few exceptions, Latin American governments have refused to modernize their societies for fear of the uncertainty, individuality, and democratic processes that would ensue. The statist model that emerges from such a tradeoff, exchanges efficiency for protection against both external and internal competition. The instruments used for protection include trade and industrial policies, which in turn have produced recurrent crises. Even those countries that have achieved a measure of economic stability still display the remnants of erroneous government decisions concerning private property. A prime manifestation of this is the existence of a large informal sector outside the do-

main of the state, which evolved as a reaction against governmental abuse of executive and legislative coercive power, failure to provide a stable institutional environment and ineffectiveness in managing the judicial system. Since informal activities are outside the law, property rights cannot be fully protected in an informal environment. Therefore the gains from a well-defined system of property rights and effective systems of risk management are lost as informal markets develop, locking out potential sources of growth.

A common feature of Latin American economies is that commerce is governed by the civil code, in contrast to the common law tradition used in the United States. Numerous observers on the relationship between law and economics have noted that precedent tends to evolve toward an economically efficient solution of disputes, so that the law evolves in the direction of promoting efficient resource allocation. This is not the case for civil law, under which precedent carries little weight and rules can be overturned by decree. In civil law countries, legislatures carry the additional responsibility of ensuring continuity and stability in the making and application of the law. No one who has studied the effects of the successive "shock" programs on the business environment in Brazil can fail to see the harmful effects of decrees that undermined the security of contracts and property rights.

### *The Destruction of Property Rights in Peru, 1968–90*

The history of Latin America is replete with instances of what appears to be blatant government disregard for property rights. The land reform and confiscation in Peru between 1968 and 1990 is illustrative of many such episodes in the region. Starting in 1968, the military junta (headed by Velasco) expropriated almost all foreign-held companies and confiscated some 85 percent of all privately held agricultural land. Part of the redistributed land was conserved in large units through cooperative arrangements and part was given over to traditional forms of collective tenure. Redistributed land was not allowed to be used for collateral (except through development banks), owned by corporations, rented, or transferred outside the family. Although a 1980 measure allowed the division of cooperatively held land among cooperative members (except for coastal sugar plantations), many beneficiaries did not gain titles, nor was a land market permitted to develop. From the mid–1980s, rural tenure was made more chaotic by the threat of massive land invasions and growing terrorism. The result was a collapse in agricultural output, as productivity on the newly collectivized land plummeted.

The García government, in power from 1985 to 1990, further infringed on property rights and discouraged investment by abrogating oil exploration and tax contracts with multinationals. The government's un-

successful attempt to nationalize banks added domestic business owners to the list of those reluctant to risk their capital in Peru.

As part of a major liberalization of agriculture, Legislative Decree 653 of August 1991 restored the free use and disposal of land within a maximum and minimum size limit, except for tenure under traditional collective arrangements (almost half of all agricultural land). Land above 5 hectares can be mortgaged, and both corporations and foreigners can own land. Although the law also simplified the legal requirements for land transactions, small farmers are still prohibited from disposing of or raising mortgages on their land, and traditional communities are prohibited from selling their land. Much rural land remains untitled.

Land invasions have created uncertain property rights in urban areas. Typically, groups of rural immigrants have invaded unused, often government-owned land to create informal townships (*pueblos jovenes*). These townships have created their own informal systems of property rights (some better than others) and have negotiated with the authorities for the regularization of their collective occupation of the land. Few individual titles to land have been obtained.

*Intellectual Property Rights*

Intellectual property rights are poorly protected in many countries in Latin America. For the most part, patent and trademark laws lag far behind those in the industrial countries. The rationale for not granting protection to intellectual property has been that paying royalties constitutes a form of foreign domination that limits access to technological knowledge and thereby raises costs and impedes development. Many countries in Latin America therefore do not recognize foreign trademarks and patents. The process for domestic registration of intellectual property rights is complicated and expensive. Furthermore, it allows others to have access to the technology while registration is underway. Under the prevailing statist concept of development, technology transfers were tightly controlled, and restrictions were frequently placed on royalty payments. For example, Brazil limited trademark royalties to 1 percent of net sales and patent royalties to between 1 and 5 percent of net sales, with the rate to be determined by the National Institute of Intellectual Property. Furthermore, if the domestic recipient of intellectual property was in some way controlled by the rights owner, the royalties could be neither deducted for tax purposes nor transferred. As usual with such restrictions, the effects have often been perverse. Companies in the industrial world have been reluctant to allow use of their technology in countries where intellectual property is weakly protected.

Reform of intellectual property protection in the region has begun. Mexico, for example, has adapted its legal framework to the present realities of the international economy, in which the transfer of technology is part of a complex system of relationships among firms in different countries that go beyond the traditional payment for use of patents and trademarks. The 1991 industrial property law grants legal protection to inventions and trademarks similar to that offered in industrial countries by:

- Increasing the term of patents to twenty years
- Increasing the term of trademark registrations
- Offering patent protection for more products and processes (biotechnology, micro-organisms, pharmaceuticals and medicines)
- Introducing registration of utility models to protect simple inventions, which typically are owned by small enterprises
- Significantly restricting compulsory licenses for patented products
- Strengthening trade secrets protection.

**Box 8.1 The *Consórcio*: A Legal Innovation from Brazil**

*Consórcios* (consortia), have operated informally in Brazil for many years. They are associations formed to pool savings to purchase durable consumer goods—often furniture and automobiles—by means of self-financing. These are one form of rotating savings and credit associations (ROSCA) which are well-known savings institutions in poorer societies. They are particularly attractive in Brazil, where high inflation has driven out even the comparatively safe banking activity of auto loans. Each participant in a *consórcio* pays a fixed monthly installment for a car—say, one thirty-sixth of the price over thirty-six months. The consortium uses the month's proceeds to buy one car, and a monthly lottery is used to select which participant (of those who have not already won) will get the car. The *consórcio* is credited with having saved Brazil's car industry in the past five years.

ROSCAs usually function within small communities that can provide an effective enforcement mechanism, given the strong temptation for a participant to stop paying once he has won the lottery. The most interesting feature of the *consórcio* is an innovation that has allowed it to function on a legal basis. A 1966 law created the concept of fiduciary alienation *(alienação fiduciária)*, under which a creditor retains formal ownership and "indirect possession" of the good. Under 1971 legislation regulating automobile consortia, fiduciary alienation gives the creditor (the company organizing the *consórcio*) the means to repossess the car very rapidly, in less than twenty-four hours, because the creditor already owns the car and does not have to go to court to pursue the claim.

Early signs of improvement under this law are promising. Efforts to combat piracy have been more successful. NAFTA effectively locks in the Mexican reforms and, more importantly, introduces procedural guarantees for enforcement, making intellectual property subject to the general dispute-resolution mechanism. Mexico has aligned its laws and regulations regarding technology with those of industrial countries and has strengthened its administrative and enforcement mechanisms. Peru has gone through similar reforms which, though not yet fully tested, bring the regime into line with international standards. They have also established a new institution for enforcing intellectual property rights, thus bypassing the Peruvian court system, which is known for long delays and uncertain outcomes.

## Enforcing Property Rights

Even in those countries with well-defined property laws, enforcement is insufficient. In Uruguay, for example, property rights in both the land and the financial markets are infringed on in a variety of ways, usually involving repossession in cases of breach. Similar problems exist in most countries in the region, and they have been compounded by recent changes in these countries' constitutions. For example, in Brazil approximately 50,000 cases on tax and interest rate issues are in the court system because the recent constitution is ambiguous regarding these issues.

Although it is difficult to quantify the impact of weak enforcement of property rights on the private sector, a rough estimate can be inferred from the fact that the market value of real estate when occupied is about half what it would be if unoccupied. This explains the large number of unoccupied housing units in Montevideo: owners do not want to rent them for fear of not being able to recover their properties without incurring high costs. Brazilian real estate suffers from a similar complaint. It is difficult to rent apartments in Rio de Janeiro because of the problems associated with terminating rental contracts. The penalties are not limited to the middle and upper classes. Not only are Rio slums houses not titled, they do not exist under the law. Hence, when a sale is made, it is the key, not the property, that formally changes hands. The ill-defined nature of the property right also results in much lower prices. As in many other things, the poor bear the brunt of the failure to protect property rights.

In financial markets, creditors' rights are equally insecure. On at least two occasions the Uruguayan government has forced debt refinancing, damaging the sanctity of contracts between private parties. In Brazil, the value of long-term government bonds, supposedly fully indexed, has declined by over 80 percent over the past twenty years, because of arbitrary confiscation and enforced freezes during a series of economic shock programs designed to reduce inflation. The result has been that interest rates

on government debt have soared to reflect the risk of further policy interference.

## Collateral Issues

Existing law in Latin America is not adequate to allow the use of movable property as collateral. Fleisig (1994) documents the shortcoming of the Bolivian legal code, under which loans to finance business expansion must be based on real estate and even then must be heavily overcollateralized. To pledge movable property as security for debts, three essential conditions must be satisfied. First, a security interest must be created which allows a creditor to obtain a right of satisfaction against the assets being pledged. This means that in the event of default, the secured creditor has the reasonable expectation that the pledged assets will be used to satisfy his debt before that of the general or unsecured creditors. In most Latin American countries, creating secured interests is fraught with difficulty. For example, in Uruguay a dairy farmer can only pledge specific cows that have to be exactly identified against loans. Thus, for a bank to be able to use cattle as secured collateral, its representatives would have to be able to find the specific cattle that had been used as security rather than simply taking the pledged number of cows from the herd. This would rule out the use of inventory as collateral because even though inventory might be homogeneous, the original goods that had been pledged might not be there. Similar problems exist in all the other countries in the sample.

The second requirement for pledging moveable property is that the security interest can be perfected—lenders must be able to ensure that the collateral has not been pledged to somebody else. Information on assets that have been pledged must be readily available, but this is not the case in most countries in the region. In many, the system of recordkeeping is deficient so that it is difficult and expensive to perfect claims. Bolivia, for example, has three main registries (for real estate, motor vehicles and commercial property), as well as several other registries. Since access to any of them is difficult and filings can be easily challenged, establishing a credible claim against moveable property pledged as collateral is expensive and uncertain.

Finally, lenders must be able to enforce their rights. In the countries studied this is often difficult. First, most of them do not allow summary judgment against debtors. Second, court proceedings to repossess or liquidate assets against a claim are time consuming and expensive, taking between six months and two years, so that even if the assets are recovered, their value has greatly diminished. The result of these deficiencies is that banks are not willing to lend against movable property, greatly diminishing the ability of firms to finance growth. Since movable assets typically ac-

count for 50 percent or more of firms' investments, their leverage is correspondingly reduced. The outcome is that interest rates are higher and that financing is unavailable to large sections of the business community. The leverage available to companies in Latin America for financing investment and growth is several times lower than in the United States. A further effect of these legal shortcomings is that they prevent the emergence of markets in financial derivatives.

For companies that do have the capacity to borrow, the law favors debt over equity and inhibits the growth of equity markets. Finally, there is much ambiguity about the status of a financial guarantee given to a firm for transfers of securities between owners. Weak property rights also affect contracting: a sample of entrepreneurs interviewed said they would increase sales by 10 percent if they had more confidence that contracts were binding.

## Lessons of Institutional and Property Rights Reform

The insecurity of property rights in Latin America has inhibited secure contracting, which is necessary to support private sector development, and has perpetuated the inequality of income pervasive in the region. Unable to obtain business finance, many potential entrepreneurs cannot gain access to the formal sector and they remain in the informal sector, with deleterious effects on productivity and growth. The failure to effectively title land and dwellings makes the labor market function less efficiently—if workers cannot sell their residences, however humble, they will be less willing to move in search of formal sector employment. Lack of titling in the agricultural sector has led to the division of farmland into smaller and smaller plots many of which are no longer viable.

Fortunately, solutions to many of these problems are available. Methods have been developed to rapidly title land in both rural and urban areas at reasonable cost. There are known ways to work around the legal system to allow for collateralization, and these could be quickly implemented. Governments are becoming increasingly aware that arbitrary actions, in particular confiscation, make investors unwilling to invest. Discrimination against the intellectual property of foreigners deprives local residents of the benefits of technology. How long it will take to implement the necessary changes rests on the willingness and ability of political leaders to take decisive action rather than on advances in knowledge for dealing with these problems.

# 9
# Conclusions

The environment in which the private sector operates is determined by complex interactions among three factors: macroeconomic conditions, incentive policies, and the institutional setting. If public policy is deficient in any of these three areas, private sector activity is harmed. The Latin American experience analyzed here demonstrates that governments are much more likely to constrain private sector development than to foster it. An apt analogy is that a string can be pulled, but not pushed. Over three decades of statist interventionist policies, combined with various external shocks and crises, weakened the private sector in most countries in the region. On balance, however, there is no doubt that the environment for business in Latin America has improved substantially over the past few years as a result of the wide-ranging structural reforms undertaken.

This study of eight countries (Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, and Uruguay) highlights the major effects of such reform on the growth of the private sector. Chapter two noted that there are three main groups of obstacles to business growth in the region, as identified in surveys of the private sector: macroeconomic and political uncertainty, which reduces investment by increasing risk; an uncertain regulatory framework, which raises the degree of uncertainty of investment and other business transactions; and institutional factors, such as a lack of complementarity between public policy and the promotion of business activity.

The reforms of the past decade have largely addressed the first two groups of obstacles to business development. In particular, the reforms have helped to promote macroeconomic stability, correct relative price distortions, lower businesses' transaction costs, and improve the overall incentive structure. These results have dramatically increased the confidence of both entrepreneurs and investors and made the entire reform process more credible.

These gains now must be consolidated. In addition, further efforts are needed to address the third group of obstacles to business activity, by reforming the institutional environment for business. This involves progress

in such areas as securing property rights, reforming legal systems, improving the mechanisms of government, and reducing barriers to the efficient operation of markets.

## Macroeconomic Conditions

Macroeconomic stability supports private sector development by reducing uncertainty from large fluctuations in relative prices and domestic demand. With greater certainty, savings and investment become more attractive than holding assets either abroad or in domestic inflation hedges. Orthodox macroeconomic policies that do not distort relative prices have a better chance of success than heterodox policies to restore price stability and current account viability. However, restoring macroeconomic stability by itself does not lead to GDP growth. When there have been long periods of uncertainty and a lack of policy credibility, the private sector needs more time to be convinced that the new policy regime will be maintained and that the government will not try to use inflation to appropriate resources.

Fiscal discipline is fundamental to winning the confidence of the private sector. Large ongoing public sector deficits can be expected eventually to lead to inflation, which has a damaging impact on private sector development. Furthermore, even when a government introduces more responsible policies, it must demonstrate a credible commitment to reform, particularly if the country has a history of irresponsible macroeconomic policies.

In addition to the time needed to establish the credibility of reform, macroeconomic adjustment is aided by greater flexibility of relative prices. A macroeconomic instrument such as monetary policy is more effective when relative prices are flexible than otherwise. Flexible labor markets are also crucial for successful macroeconomic adjustment, and in this area the reform of incentive structures becomes an integral part of the process.

## Incentive Policies

Trade, finance, and the regulatory environment comprise the main incentive structures that determine the level and the structure of private sector activity.

### *Trade Policy*

Trade policy has a powerful effect on private sector activity. In the past, the distorted trade regimes that prevailed in Latin America diverted private sector activity to production for the domestic market. Earlier attempts to liberalize trade regimes and provide neutral incentives for domestic and the in-

ternational markets had failed, because of macroeconomic uncertainty and a lack of strong commitment to trade reform. Although the most recent round of reforms began in some countries as early as the mid–1970s, most countries instituted reforms in the mid– to late 1980s as a part of an overall economic reform package.

Changes in the incentive structures for private sector activity have encouraged production for the foreign market and the diversification of exports. With more stable macroeconomic policies and a greater commitment to liberal trade, these eight governments have improved to some extent the character and competitiveness of the private sector. However, reform could be reversed in certain sectors such as agriculture, as a result of declining prices and the reassertion of special interests. There could also be attempts to use exceptional protections—such as reference prices, antidumping, safeguards, and countervailing laws—to reinstate some of the protection lost during liberalization. Making the new trade and regulatory institutions transparent and binding under GATT, along with maintaining stable macroeconomic policies, will help to prevent such reversals.

*The Financial Sector*

The financial sector plays a vital role in promoting private sector development. Without effective intermediation between savers and investors, financing for growth is limited to existing businesses. This explains at least in part why there is such an unequal distribution of income in most countries in the region: systems that are nontransparent and discretionary discourage entrepreneurial activity.

Beyond the necessary phases of stabilization and adjustment, governments must find an appropriate balance between financial liberalization and sound regulation and supervision. There is a pressing need to support money and capital market development, which implies deepening financial markets and enhancing their efficiency in mobilizing and allocating domestic and foreign financial resources. To be successful, these initiatives have to be complemented by legal reform and institutional development. Apart from sound macroeconomic management, the reform process should work toward developing capital markets that allow a greater variety of financial activities and longer maturities. These markets, in turn, will allow private sector activities to be financed at lower cost, thereby increasing efficiency.

*Regulatory Environment*

As the state withdraws from many areas and activities for which it does not appear to be well suited, the need for effective regulation increases. However, many companies in the private sector are still burdened with over-

zealous regulation by all levels of government. This is exacerbated by the lack of coordination between different levels of government; state and municipal regulations frequently contradict federal rules. Significant reform is needed, but it will be a long and complex process.

In addition, new types of regulation are needed to deal with some of the newly privatized industries, particularly where natural monopolies exist. The public must be assured that standards of fairness prevail in the process of privatization. In implementing regulations, a particular country's institutional strengths and weaknesses must be considered—imposing elaborate regulatory mechanisms where institutions and skills are poorly developed or absent invites failure. Regulatory activity should be limited to the three areas in which government regulation is most often effective: natural monopolies, anticompetitive markets, and inadequate consumer protection, and environmental safety.

*Privatization*

Privatization in the region has had strong positive results. Substantial proceeds were realized from the sale of assets, efficiency was enhanced in the newly privatized industries, and new owners made substantial investments. The improved incentives have achieved the goal of increasing efficiency. The more extensive the privatization process, the greater the credibility of the government's commitment to reform. In fact, preliminary evidence indicates that the speed of privatization is linked to the rate of GDP growth: investors realize that a reform effort under which most state-owned enterprises are sold off is far harder to reverse than one under which the state maintains control of numerous enterprises and sectors. Extensive privatization is one of the strongest signals a government can give of its long-term political commitment to reform. Although in some countries privatization programs have lost momentum, in others they are proceeding apace—a development that will enhance welfare throughout the region.

## Institutional Policies

Macroeconomic reform and regulatory and incentive reform constitute the "first generation" of economic reform programs. The "second generation" of reforms involves restructuring the institutions that strongly affect the business environment.

*Property Rights*

Insecure property rights—both in land and in assets in general—are a problem throughout the region. Because it is costly and difficult to title both rural and urban fixed property, property values are lower than they other-

wise would be. Property markets do not work efficiently, hampering the functioning of other markets, in particular the labor market. Agricultural investment and output are also adversely affected. The difficulty or impossibility of using movable property as security for borrowing, restricts financing for businesses. Fortunately, methods of dealing with both these problems have been developed. Unfortunately, their implementation is proceeding slowly, at best.

*Legal Systems*

There are many deficiencies in the legal systems in the countries studied. But an even greater problem is inadequate enforcement of existing laws. The Brazilian saying, "To my enemies, I wish the law!" is apt for most Latin American countries. The contracting environment is poor; dispute-resolution mechanisms are ineffective; the extrajudicial mechanisms for settling disagreements work poorly or not at all; and court procedures are so slow as to be considered useless by many in the business community. The already strong tendencies for wealth to be concentrated are exacerbated because impersonal, long-term, and spatially separated contracts involve added risk, making it prudent for entrepreneurs to deal only with people they know.

## Lessons for Reform

The most important lesson from the reform experiences of these eight Latin American countries is that a great number of factors influence the business environment in complex ways. A business environment that promotes private sector growth is easy to destroy and difficult to restore. The ingenuity of the business community in dealing with adversity contrasts remarkably with the business environment's susceptibility to policy shocks. Although individuals can struggle to overcome adverse business circumstances, the sum of such adversities can have severe consequences for investment, resource allocation, efficiency, and economic growth.

Ample experience from the Latin American private sector has demonstrated that government intervention to promote more rapid growth, or to promote a particular pattern of development, rarely works and often does serious harm to the structure of incentives. While not all direct intervention is necessarily bad, the onus is on the proponents of such actions to prove that they will work. There are very few instances of government policies to promote increases in investment and output having succeeded, and many failures. Governments have failed not only to manage enterprises owned by the state but also to effectively provide public goods and services, which are the foundation of a healthy business environment. Clearly, future reform efforts should focus on strengthening institutions, property rights, the contracting environment, infrastructure, and education. Such reforms will

truly unshackle the private sector and allow it to grow to its full potential.

Another lesson of the reform experience of Latin America is that changing incentives and the way resources are allocated requires actions in many areas. Macroeconomic reform and incentive reform will not work well without institutional reform. Similarly, attempting to reform institutions in an unstable macroeconomic environment or in one in which price signals do not reflect scarcities will do little good. This type of reform is a large package that needs to be tackled simultaneously on all fronts.

In terms of specific priorities, the measures taken in Peru provide a lesson with broader ramifications for Latin America. Reforming the macroeconomic climate and the trade system took priority in Peru, but accompanying it was a vigorous privatization program that has been unmatched in speed and breadth. Although Peru's history of institutional instability had discouraged investors in the past, the credibility of the reform effort was greatly bolstered by privatization. Subsequently, the more painstaking, longer-term and more difficult process of institutional reform has begun, concentrating on tax collection, intellectual property rights, and land titling. Given the extremely strong growth performance of the economy after a period of near devastation, this appears to have been the correct mix of priorities and measures. While other countries require their own particular agenda, there is much to be learned from the Peruvian experience.

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