Iberoamericana. Nordic Journal of Latin American and Caribbean Studies
Vol. XXVIII: 1-2 1998, pp. 85-102

Emerging Economic Issues in Latin America: A Second Generation Agenda

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I. Introduction

Starting with Chile in 1973 and then with many other counties in the decade from the mid 1980s, most countries in Latin America embarked on episodes of economic reform which in many cases were quite radical. Inflationary, inward-looking and distortionary policies were, in the most part, abandoned. They were replaced by fiscal priority which reduced the chronically high inflation that were a characteristic of the region. Trade reforms removed quantitative restrictions and lowered and simplified tariffs. Financial reform removed financial repression. Exchange rate restrictions were replaced by policies that often included full convertibility and large scale privatizations reduced state ownership in most countries. Elsewhere we have characterized reform programs (Holden and Rajapatirani, 1995). Those that involve changes in macroeconomic variables, we described as *first generation reforms*.[1] They prepare the ground work for creating the conditions for *second generation reforms*, or reforms at the microeconomic level which are needed to make the changes brought about by the first generation reforms sustainable.

Second generation issues focus on removing impediments to the shifting of resources in response to improved incentives. They increase an economy's ability to withstand external shocks. They more strongly define property rights. They reform institutions by making their role more automatic than discretionary in order to reduce the probability of disequilibrium induced by policy reversals or other endogenous developments. The second generation agenda also relates to increased concerns regarding income distribution, small- and medium-sized enterprises and decentralization and power sharing between the central government, provinces and municipalities.

A second generation reform agenda sets out to address a focus of critcism arising from Washington Consensus type reform, namely, the benefits of the process only accrue to relatively small numbers of the

doi:https://doi.org/10.16993/ibero.266

'power elite.' Whether or not this perception is in accordance with the facts, there is no doubt that institutions in Latin America do not adequately support many activities that function as a matter of course in the more developed world. Insecure property rights, inadequate dispute resolution mechanism, stifling regulation, and poorly functioning legal systems conspire to stack the deck against upward mobility and the diffusion of wealth and power. Simple political economy considerations dictate that the present value of the gains to reform needs to be larger than the present value of income from existing policies, and that these gains are so distributed that wide and enduring support for the policies that have been put in place can be sustained. This implies the need to assure that the gains from reforms are widely distributed, that the gainers are made sufficiently strong to support continuing reforms and the vulnerable groups in society are protected during the reforms. The second generation agenda is aimed at securing the sustaining and supporting political economy ethos that leads to the initiation, acceptance and maintenance of reforms over time.

The paper is divided into six sections. Following the introduction, section II recounts the host of policy reforms undertaken under the first generation agenda and the outcomes of these reforms. Section III describes the unfinished elements of the first generation. Section IV places second generation issues within an overall reform strategy, while Section V develops some specific elements of the second generation agenda. Section VI gives conclusions.

II. First Generation Reforms and Outcomes

There has been a pattern to the recent reform and stabilization efforts. They started with Chile in the early 1970s and were implemented from the mid 1980s onwards in most other Latin American countries. Reform tended to be followed by recovery, then subjected to stress, which needed a correction, which was then followed by post reform sustainability. Chile, which has had the longest period of time for reform to have shown results, appears to have completed the first generation reforms well and put the economy on a self-sustaining path, but it now needs to complete the second generation agenda.

In the mid-eighties, most countries in Latin America were in the throes of severe macroeconomic disequilibrium. Starting with the Mexican debt crisis of 1982 and continuing through most of the 1980s, inflation had become rampant, with Argentina, Brazil and Bolivia experiencing hyperinflation. Current account deficits had become unsustainable. Nearly all countries, with the exception of Colombia and Uruguay, had suspended debt service payments. Unemployment was widespread. Real wages had plummeted in most countries despite indexation. Appreciated exchange rates, biases arising from import restrictions and softening world prices, combined to keep export revenues low and declining. Imports came to be severely resticted to accommodate the falling exports and to generate surpluses to pay off the high external debt that had been accumulated and capital flight was large.

Financial markets were severely controlled; interest rates were fixed administratively and selective credit controls were widely used which resulted in severe financial market repression in many countries. There were some exceptions. Indexation of instruments allowed for market determined interest rates in Brazil. In the late 1980s, Uruguay maintained an open capital account to encourage foreign capital inflows that made interest controls non-viable. Chile was recovering from its severe financial and banking crisis, with the state taking over many of the non-performing assets and forcing the commercial banks to adjust their portfolios to more viable positions.

This period of crisis brutally exposed the non-viability of the inward-oriented strategies followed by many Latin American countries. The success of other developing countries such as those in East Asia following outward-oriented policies also demonstrated that the region needed a different paradigm of development. The crisis triggered reforms ranging from macroeconomic stabilization and adjustment policies to incentive reforms and privatization. Table 1 summarizes the experience with the reforms over this period.

Table 1 - PATTERNS OF REFORM IN LATIN AMERICA: 1975-1996

Country	Reform	Recovery	Stress	Correction	Post Reform
Argentina	1991	1991-1993	1994	1995-1996	
Bolivia	1985	1988-1990			
Brazil	1994	1994-1995	1995		
Chile	1975	1976-1980	1981	1982-1985	1986-1997
Mexico	1988	1991-1993	1994	1995-1996	
Uruguay	1990	1991-1994		1995	
Venezuela	1989	1990-1992	1993	1994-1995	

Source: Inter-American Development Bank, Annual Report 1996 and authors' estimates.

The main issue is how to make the stabilization and macroeconomic adjustment stick; or in other words, to lead to a higher and stable steady state growth. Many analysts believe that only Chile has achieved such a steady state by completing the first generation reforms and accomplishing some of the second generation agenda. However, the large majority of Latin American countries have yet to achieve this status as evidenced by the sharp reductions in activity and the instability that was the result of the "Tequila shock" when Mexico found itself unable to meet its short-term dollar denominated Tesobonos. The crisis spread to Argentina, which experienced a strong adverse shock, leading to high unemployment and zero GDP growth. The aftermath of the Mexican peso crisis clouded the economic performance of the whole region, especially Brazil. It points to the vulnerability of the economies when even first generation reforms are not fully realized. In Mexico's case, the lesson is that the country was not able to keep its fiscal accounts in balance, a problem that was greatly magnified by large amounts of highly volatile short term debt and the underlying weaknesses in the commercial bank portfolios. The good news is that despite the stresses and with some outside assistance, Mexico Argentina and Brazil, did not abandon their first generation reforms. Mexico received a US$ 40 billion infusion of resources fom the US, the IMF and the World Bank. Argentina held steadfast to its convertibility plan. Although Brazil did increase some tariffs for revenue purposes, the main elements of its reform agenda remained in place.

Most Latin American countries have progressed rapidly toward opening up their economies although not all countries liberalized their trade regimes at the same time or to the same extent. Chile again led the way, followed by Bolivia, Argentina, Mexico, Peru and Uruguay. Most countries in Latin America are more open today than anytime in their post-world war history. As a result, both imports and exports have grown rapidly. For example, except for Mexico and Argentina in 1995, imports grew at 9% on an average in the last five years. Similarly, exports grew at about 7-8% during the decade and the composition of exports changed towards manufactured goods. The increase in exports was supported to some extent by the regional trading agreements. One example of exceptional growth in bilateral trade is between Colombia and Venezuela. Not all the increases in such trade have been beneficial, since the sources of imports were not lowest cost. This entails some trade division and created new forms of protection arising from the enforcement of "rules of origin." In joining the GATT and its successor, the WTO, the countries have agreed to further reduction in tariffs and the adoption of WTO rules with respect to exceptional protection, such as anti-dumping, safeguards, and countervailing duties.

As a result of the trade reforms, a majority of the countries in the region have low tariffs, a very low incidence of non-tariffs barriers and no exchange controls on current account transactions. Among the 27 countries in the region, average tariffs fell from 44.6% during mid-1980s to 13.1% by 1995. Only seven countries have average tariffs over 15%. And only two countries apply maximum tariffs over 100% to a small number of goods, mostly agricultural goods, to protect farmers. Only Brazil, Mexico, and El Salvador have non-tariff barriers affecting more than 5% of their imports.

This integration with the world economy has had tremendous implications for productivity in these economies and has provided a guard against macroeconomic excuses. Overly expansionary policies quickly manifest themselves in a loss of international reserves and give signals to policy makers that restraint is warranted.

Financial repression was common place in Latin America in the 1980s. However, in most countries financial reforms have focused on reducing or eliminating directed credit programs, letting interest rates be market determined, lowering reserve requirements and introducing regulations that lead to prudential management of banks. In addition, many banks have been privatized. These reforms have gone the farthest in Chile, Peru and Argentina.

Privatization and the adoption of neutral regulatory environments that have broken the link between ownership and regulation have been widespread. These reforms have been adopted to increase competition in the non-tradable sectors, where trade liberalization does not result in more competition. Privatization was undertaken on a large scale in Mexico, Argentina, Peru and Paraguay, but was more limited in Uruguay, Ecuador, Brazil, and Venezuela. Sales of government assets have ranged from telecommunications privatizations in Mexico, Argentina, Venezuela and Chile to the privatization and downsizing of railways in Argentina and power generation and port services in Uruguay. Since privatization often results in private operations obtaining monopoly positions, a framework for regulation had to be developed in most countries in the region. The state has become the regulator rather than the owner.

Structural reform of rigid labor markets that exist in many Latin American countries has been limited. For example, in Argentina entrenched labor unions were a powerful block against reforms, and have strongly resisted attempts to change labor legislation. However, recently progress has been made towards changing some of the more distortionary rules. A similar situation exists in Uruguay where some progress has been made in labor market reform. Reform has languished in many countries, however. More typically, governments have tried to come to an understanding with the labor movement that exchanged job security and promises of future benefits for current wage restraints. Mexico is an example, where a "Pacto," or understanding with the labor unions to restrain their claims for wage increases was implicitly exchanged for the assurance that as the economy recovered following reform, labour would be extended a share of the benefits arising from increased productivity. In many countries, including the successful reformers such as Chile, labor has begun to demand more than what have been promised to them from the reforms. Similar opposition has arisen in many parts of Latin America, from Ecuador to Argentina, and from Brazil to Venezuela.

As far as institutional aspects of the first generation agenda is concerned there has been little progress. For example, independent Central Banks, which can resist political pressures to inflate from Ministries of Finance or Treasuries, are not common and exist only in Chile, Colombia and Argentina. Few countries have achieved reform in the institutions that govern their international trade. Argentina, Colombia, Chile and Peru have made some changes in the direction of ensuring that their trade policy institutions reflect national rather than sectoral interests by removing the responsibility of trade policy making from sector ministries. But even in these cases, sector interests have remained influential. For example, Colombia has introduced agricultural protection through a system of price bands and minimum prices, a policy that is now emulated by the other partners in the Andean Pact.

III. Unfinished Elements of the First Generation Agenda

In spite of the widespread nature of the reforms, many countries in Latin America remain vulnerable. External macroeconomic shocks such as terms of trade or interest rate disturbances are inevitable as countries become more integrated with the world economy. However, many countries in the region are also vulnerable to policy induced or endogenous shocks which have their origin in fiscal expansion, as was the case in Mexico in 1994. At the same time, countries such as Brazil continue to have difficulties in controlling fiscal excesses, particularly those arising from state government spending. A similar situation exists in Argentina, where in the past, budget deficits of state governments have been routinely financed by the central bank or the federal government. In other cases, as in Uruguay, fiscal situations have been improved through such transitory measures as using the monopoly position of public enterprises to benefit from improved world market prices in their monopoly imports. Thus, there is no assurance that permanent fiscal discipline has been achieved. In addition, there are contingent claims on many governments in Latin America arising from unfunded social security liabilities. The problem is especially acute in Uruguay, Mexico and Colombia.

There is as yet no evidence that the permanent budget constraint that governments have to face has been dealt with systematically in the region. In most cases, reductions in government deficits have come from revenue increases rather than through cuts in permanent expenditures. In many cases the improved revenues are transitory, either generated from the once and for all realization of funds from the sale of public assets or through short-term improvements in the terms of trade. Weak fiscal policy could therefore still introduce instability and cause endogenous shocks. Furthermore, with the return to democracy fiscal discipline often weaken as elections approach, as was dramatically demonstrated in Mexico, and noticeably but less dramatically in Costa Rica, Colombia and Ecuador.

In trade the unfinished agenda relates to reducing protection further and reducing the variance in tariffs to achieve more uniform rates. In addition, the exceptions given to different activities must be reduced and institutions established which are more sector neutral in policy making. There is also the danger that additional trade barriers could emanate from the rules of origin requirements or regional trading agreements. Further elements of the unfinished trade agenda include fulfilling obligations signed under the Uruguay round not only with respect to reducing protection and binding tariffs, but also in adopting WTO rules with respect to exceptional protection.

In finance, improving the supervisory and prudential rules and creating conditions that are necessary for the emergence of long-term financial instruments are top priorities of the unfinished agenda. Supervisory and prudential regulation is in a rudimentary state in most countries in Latin America. Regulatory authorities are not in a position to monitor the quality of bank assets and as a result many banks carry assets that are non-realizeable. In Uruguay, for example, commercial banks have been ordered by the Central Bank to lend to enterprises that are experiencing serious financial difficulties. As a result, many banks carry assets that are non-performing, which makes the banking system highly vulnerable to shocks. A similar situation is to be found in Bolivia, Colombia and Mexico. State-owned banks in Argentina are also extremely weak. In addition, inadequate laws related to collateral have seriously hampered development of financial systems in Latin America. These are discussed in detail in the section on the second generation agenda.

In privatization, most pubic assets have been divested in the countries that have been in the forefront of reforms as, for example, in Chile, Argentina and Peru. However, in the majority of countries there are many public assets that could be owned by the private sector. Uruguay has resisted the privatization of telecommunications, Brazil continues to own large parts of public utilities and many other activities that could be better run by the private sector, such as petroleum and sugar production.

A similar unfinished agenda exists in making key institutions of public policy such as Central Banks, trade institutions and regulatory bodies less vulnerable to political pressure. Institutions must anchor the reforms in such a way that they give assurance to the markets and to the business community that they will not be the cause of endogenous shocks to the economy and that they will react in predictable ways to external shocks. So far serious progress in institutional reforms has been achieved only in Chile.

IV. THE SECOND GENERATION AGENDA AND REFORM STRATEGY

Second generation issues relate to property rights, the legal system and institutions. Most of them have public goods characteristics and therefore involve the state. Thus, a key aspect of the second generation agenda is how to define and structure the role of the state. In the past, many of the problems that arose in the region could be traced to the excess intervention of the state in some areas of economic life and its near total absence in others. The second generation agenda therefore begins with a re-evaluation of the role of the state in the economy. In the past, the state in Latin America has over-extended itself in areas of regulation and control of economic activity. At the same time it seriously neglected its fundamental role in proper macroeconomic management, maintaining law and order, assuring property rights, and providing basic services such as public utilities, education, health, and other public goods. Some form of these interventions is appropriate either because of the lack of markets or because of the failure of the private sector to engage in these activities. In addition, the state has the obligation to provide equal opportunities to the citizenry who do not have the financial means to acquire education or physical assets to raise their living standards.

While the role of the state differs in different environments, there is by now common agreement that its presence was too pervasive in Latin America. In the 1930s and 1940s doubts about the ability of the capitalist system to deliver basic services and ethos favourable to a state-centred paradigm of development evolved in the LAC Region. During the 1950s, this paradigm received the intellectual support from the economic Commission for Latin America and the Caribbean under the leadership of Raul Prebisch and Celso Furtado. The Structuralist school of economic development expounded by such economists as Ragnar Nurkse, Dudley Seers and Hans Singer championed industrial development behind protectionist walls. In such a paradigm, the state becomes powerful not only because it can acquire monopoly and non-contestable power in an economy but also by default through over-regulation of those sectors of the economy that remain in private hands. An example of the acquisition of power by the state in the region can be seen in the state takeover in many countries of infrastructure such as railways, power, and telecommunications that had been in the hands of the private sector. Regulation become so pervasive that private entrepreneurs who were operating in these sectors virtually handed their assets over to the state because they could not bring adequate returns. This tendency to over-regulate was enhanced by the emergence of military dictatorships in the region.

Thus, the first aspect of the second generation agenda is to redefine the role of the state to:

- let it undertake those activities that are public goods or quasi public goods;
- to ensure that regulation leads to competitive solutions;
- exit from those activities in which it has no comparative advantage.

Democracy demands that the power of the state be a residual that is harnessed for the public welfare. With the return to democracy in Latin America this limited and focused role can be achieved. Privatization of activities better performed by the private sector, reducing the arbitrariness of policy making and separating ownership from regulation are essential elements in the redefinition of the state.

The second aspect of the second generation agenda is the need to clearly delineate the rules that govern contracting and to define property rights. In Latin America, rights for both movable and fixed property are poorly defined, which raises transactions costs, discourages investment and hinders financial development. The intricacies and lack of clear resolution of commercial law and the difficulties of enforcing contracts tends to concentrate economic power and reduce upward economic mobility. The legal system is itself deficient for the efficient conduct of business. Legal processes take time and outcomes of litigation are biased against business. The lack of proper recording systems and of acquaintance of judges with the law relating to commercial transactions makes the business environment costly.

Related to these issues is the need for attention to the conditions in which small- and medium-sized businesses operate. Firms in Latin America tend to be large and long lived. Compared with say the United States, there appears to be few examples of small businesses growing into powerful enterprises. Conditions governing business formation, regulations governing small business operation and in particular the evolution of financial markets that can finance the growth of business are all part of the second generation agenda.

The third aspect of the second generation agenda relates to the addressing of income distribution and poverty reduction. The crises that led to the first generation reforms may have created larger burdens of adjustment on some segments of society that formerly had received various subsidies such as the urban industrial workers. While a major part of the subsidies has been appropriated by the middle class, the cuts in domestic expenditures have fallen disproportionately on the poor, who have either little or no ability to protect themselves when prices are adjusted to international levels. These effects are compounded when expenditure on primary education and health are cut. The second generation agenda has to address this issue targeting expenditures to the more deserving segments of the society when they come under stress during periods of adjustment. It is no accident that the best means of testing for the provision of these services is found in Chile, which was the earliest to undertake reforms and preserved the policy regimes put in place following the return to democracy.

The fourth aspect of the second generation agenda is the balance in power sharing and the roles of the central government and the states, provinces, and municipalities. Such power sharing ensures that decisions regarding resource allocation and administration are made by the parties who are the most affected. However, the capabilities of sub-national governments are often hampered by the paucity of skilled officials. In addition, even when the economy has been reformed at the national level, vestiges of controls can remain at the local level and prevent the achievement of gains from reform being fully realized. Therefore, the second generation reform agenda has both to raise the competence of local government as well as to redefine its role in local regulation.

The fifth aspect of the second generation agenda relates to the political economy of macroeconomic adjustment, policy reform, and institutional change. The main issue here is how to assure sustainability of the new paradigm. Under the new order, activities of the state reflect its comparative advantage, the economy becomes integrated with the world economy, property rights are clearly defined and policymaking is made more automatic through institutions that are insulated from day-to-day political influence. However, this agenda cannot be carried out without inducing changes in the political economy equilibrium. In the large majority of cases, policy change was possible because there were crises that allowed or even forced governments to undertake reforms that were in the national interest. Crises allowed the break-up of old coalitions and the formation of new ones that were prepared to support reform. These coalitions probably cannot exist in the medium- to long-term if there is no conscious effort on the part of the government to develop support for the next generation of reforms that can lead to a steady state growth path. While trade, financial, and regulatory reforms will help to raise income and employment in the short- to medium-run, a sustained coalition is needed to achieve such an agenda in the long-term. When a short-run coalition (the "pacto") was formed between government and labor in Mexico in the late 1980s it implied that labor would acquiesce in a lower rate of growth of real wages and would help to achieve the increase in productivity that the government is seeking. But when the 1994 crisis hit, real interest rates rose to inordinate levels and the unemployment rate increased sharply thereby undermining the contract. When it does not anticipate gains, labor refuses to acquiesce. Thus second generation reform cannot be achieved without a long-term coalition of broad elements of society. Without it, economies can progress for a short while and experience a recovery of growth, low inflation and improved employment, but these achievements can be reversed either due to external shocks or through endogenous events related to the bad policy. Once the confidence of the public is broken, it is difficult to achieve the second generation agenda.

V. SOME SPECIFIC ELEMENTS OF THE SECOND GENERATION AGENDA

The shift from relying on the state to decide on the allocation of resources to relying on markets to perform this task naturally focuses attention on the set of rules that govern the working of markets, and whether they successfully create an environment which produces:

- efficient conditions for assembling capital –be it physical, financial or human
- a clear definition of property rights
- equality in the administration of laws in civil disputes
- the efficient enforcement of contracts

Property Rights

Secure individual property rights are the foundation of an efficient market economy. The multiple effects of secure property – the motivation to invest and resources to obtain and improve property, to put it to productive uses and to freely sell it – have often been underestimated as factors in the development of a free market system, particularly among the poorer sections of the society.

The exchange of property on the markets require formalized titles, which can be obtained and exchanged with relative ease. In many Latin American countries, a very large percentage of rural and urban real estate property is not titled. This lack of a clear definition of property rights has a disproportionate impact on smaller businesses and on start-up finance. In particular, owners of small businesses are frequently unable to use property as collateral for credit from formal financial institutions. In addition, property registration procedures are costly and time-consuming. Excessive fees for registration and for the mortgaging of real estate, in some cases due to a strong oligopoly of public notaries, raise costs and inhibit the development of mortgage markets, one of the most important sources of finances of small business start-ups in North America.

The absence of a property market in which dwellings can be freely titled, bought and sold with comparatively low transactions costs also has a negative effect on the functioning of labor markets. If occupational title is the sole basis of ownership, workers have only a restricted area in which they can seek employment. If jobs become available in areas which would require relocating dwellings, the costs of taking such employment are very high. Frictional unemployment is therefore probably much larger in Latin America than in the industrialized world.

Anomalies in the law governing property have other negative effects. For example, in many Latin American countries, the government owns all sub-surface resources regardless of the ownership of the land. This has a negative effect on mineral exploration – the incentives to explore private land are greatly weakened if the government has the right to whatever is found.

Property Rights and Financial Repression

Poorly defined property rights also have a profound impact on the operation of financial markets. This inability to pledge movable property – business assets such as inventory, machinery, and accounts receivable – has resulted in severely underdeveloped financial markets. Comparing the financial systems in industrial countries with those in Latin America, it is apparent that first, a broad array of specialized financial banks which predominate in the financial sectors[2] of all countries in Latin America lend only to large, well-established firms. Since all sources of funds except equity, retained earnings and trade credit are unavailable to smaller businesses that wish to expand, they cannot grow as fast as they would if financial markets were more developed. Decisions regarding which technology to adopt in production of how much inventory to hold or whether to expand does not depend on the track record of the people running the business and their ability to convince lenders that the ideas are sound. Rather it depends on personal circumstances and specifically on the owner's real estate holdings. The alternatives available to entrepreneurs whose personal asset holdings are not large are limited and have profound efficiency consequences for their businesses and more generally for the allocation of resources and the distribution of income (Fleisig, 1996).

The extent of financial repression in Latin America can be seen in the ratio of credit to the private sector provided by the financial system in various countries. In Germany and the United States, the outstanding credit to the private sector equals or exceeds GDP – that is, the outstanding credit to the private sector is equivalent to at least one year's output of the economy. In Singapore and Thailand, the rapid growth of credit mirrors the high growth rates registered by both countries. Countries in Latin America stand in dramatic contrast. Even after years in which the amount of credit granted by the banking system grew rapidly, in no Latin American country did credit from the banking system to the private sector exceed 50% of GDP at the end of 1994. In many countries in the region, the ratio was far lower. In Peru and Argentina which implemented the most rapid and radical reforms, the ratio of credit to GDP is around 20% even after several years of rapid growth. It is hard to believe that high growth rates can continue without substantial expansion of financing of the private sector. The picture is similar in Colombia, Venezuela, Costa Rica and to a lesser degree Mexico, Chile and Brazil. It reflects an astonishing degree of financial underdevelopment and reflects an urgent need for secured transactions reforms (Holden, 1996).

Commercial Codes

Although many of the commercial codes in Latin American countries require reform, many of the most significant impediments to small business development emanate from enforcement:

(a) *Interpretation of the law.* The courts remain overly timid and rigid in their interpretation of the law, bound to commercial transactions defined explicitly in the Code. Although judges are often granted discretion to look to commercial customs when adjudicating cases involving new types of commercial transactions, their reluctance to set precedents prevents commercial actors from engaging in such transactions. Unless judges are confident enough in their authority to depart from the Code and are cognizant enough of modern commercial arrangements to do so responsibly, the Code remains underutilized.

(b) *The inadequacy of related laws.* In one extreme case, for example, the law governing the public certification of documents dates from 1859 and requires that documents be handwritten by a notary. In other cases, lack of clarity and contradictions between related laws, decrees and ordinances promulgated over the year increase legal uncertainty.

(c) *The lack of independence from the legislative and executive branches.* A manifestation of this problem is the low prestige of badly paid court judges. This leads to negative selection and encourages corruption.

(d) *Court structure and court procedures.* In many countries, no specialized commercial courts exists nor is out-of-court arbitration and conciliation instituted, increasing the burden of dispute resolution on the main court system and exacerbating the length and cost of obtaining justice. In other cases, court organization is highly inefficient and often requires bribes to expedite cases. Such delays and costs in the legal enforcement of contracts constitute a significant impediment to the expansion of impersonal contracting.

The negative impact of this factor falls disproportionately on SMEs, whose transactions are too small to merit the effort required to deal with inefficient legal structures.

Labor Laws

In most Latin American countries, organized labor has, through processes of negotiation and political pressure similar to the lobbying of large enterprises, obtained a number of protection benefits forged into laws, in some cases rights up to the Constitution. Some of the corresponding policies affect conditions of employment directly, like severance pay or reducing the length of the work week. Other policies have been designed to affect the compensation of work, like minimum wage legislation, rules regarding union formation or centralized wage setting. Action to affect work conditions included pension requirements, health care and safety standards. Social overhead costs in formal enterprises range from 30% to 80% of the base salary, discouraging formal employment and providing incentives for informal employment arrangements. Overall, such rigidities have detrimental social consequences, excluding a majority of the labor force from its benefits and encouraging informality.

Tax Laws

In many Latin American countries tax laws are complicated and expensive to comply with. In Brazil, Stone, Levy and Paredes (1992) conducted interviews with small entrepreneurs and discovered more than 50 federal, state and municipal taxes, some of which require monthly contributions. Such complexity, further compounded by arbitrary enforcement, encourages evasion. In many Latin American countries, formal small businesses establish double bookkeeping, one for the tax authorities to minimize the tax burden, and another which corresponds to reality. If, on top of such complexity and inconsistency, marginal tax rates are high, that honesty is penalized.

A first step to facilitate formal integration of SMEs would be the creation of a simpler overall tax system. The Bolivian tax reform of 1986, for example, succeeded in reducing the chaos of taxes to seven basic ones and prohibited the creation of new ones which were not in accordance with the principles of the new tax system. A second, equally important step is the creation of a tax enforcement mechanism, which employs committed, well-paid professionals. Such measures must be part of a wider civil service reform, which increases the credibility in the performance of the public sector and therefore the disposition of economic agents to pay taxes. A third step,finally, involves simplifying taxes for SMEs and adjusting the tax burden to their economic capacity.

Business Licensing

The famous empirical study by the Instituto Liberdad y Democracia in Lima under the leadership of Hernando de Soto (1989) has shed light on the costs of formal business registration by small enterprises: it took 289 days to fully comply with all formal requirements to set up a small firm. In practice, it is not necessary to comply with all these formal requirements to start a business and there is a large gray zone of non-compliance that reaches right up to large enterprises. In addition, "fixers" exist in many Latin American countries who, for a fee, will deal with bureaucratic problems. Still, other empirical evidence (Tokman 1992) shows that formality is substantially discouraged by the cumulative effect of regulatory requirements of different public agencies. In many Latin American countries, business licensing can be simplified substantially with a number of fairly straight forward reforms.

A second area of reform concerns the simplification of representation of publicly certified documents to different agencies. Finally, business registrations should be modernized, maintained and publicly accessible.

Government Reform

Many of the issues discussed in the preceding paragraph involve actions by the State. Although views regarding the appropriate role of government in the economy may differ, there seems to be a broad consensus that before the reforms began to be implemented in Latin America, most governments in the region has assumed roles for themselves that were far too extensive. As a result, interference by the state in economic life was pervasive with strong adverse effects on efficiency and productivity. Much of this remains. Although state owned enterprises have been sold in many of the countries in the region, numerous regulations and restrictions remain that impinge on economic life. At the same time, however, public goods necessary for the efficient conduct of business transactions are missing. The insecurity of property rights discussed at length earlier in the paper is a reflection of government failure. The state has a comparative advantage in supplying these and other public goods. In Latin America, most states fail abysmally at doing so. At the same time, the lack of transparency promotes opportunistic behaviour by government officials that is manifested in corruption in many countries.

Yet there is no agreed upon model for reform of the state. There are reasons to believe that the radical approaches to governmental reforms adopted by such countries as New Zealand may not be applicable in Latin America. In particular, the relative underdevelopment of political and institutional frameworks in the regions could make the methods used by the reforming industrial countries ineffective. Instead, there appears to be little alternative to first improving the basics of public administration – effective planning and budget systems, personnel control and improved reporting accountability and transparency which is the first step towards professionalizing the public service. Without this step, further attempts at state reform are probably doomed to failure.

VI. CONCLUSIONS

A number of important lessons can be drawn from Latin America's reform experience over the past ten years. Excessive and improper government intervention restrains private sector activity more than it can help to support it and ultimately damages efforts to promote development. Although much progress has been made in reaching macroeconomic stability and in implementing financial and trade reform, the business environment is fragile and susceptible to damage by misguided policies. The region faces new challenges in addressing the second generation of private sector development issues – especially those related to the role of the state, to institutional structures, and to property rights.

The transition to steady state growth is not easy; it requires more effort to anchor the reforms. The process will not be an easy one. Only a participatory, locally anchored, common effort has a chance to mobilize the required forces to implement reforms, often against powerful constituencies or with the benign neglect of important actors. It goes beyond traditional ideas of reforms, to take into account property rights, the legal system, institutions and political economy aspects of managing an economy. It is equally important that reforms are well-devised and implemented, if they are not to create further uncertainty for investors, small and large. Improving the economic environment is a demanding task that requires the full attention of policy makers, the public administration and private sector representatives. The fundamental importance of "getting the basics right" – macroeconomic stability, clear and consistently enforced rules and property rights for better functioning markets, steadily improving human capital and infrastructure, increasing savings and investment – has been highlighted by the success of the highly performing East-Asian countries. The aggregate affect will have far greater impact on economic development in Latin America than any direct promotional measures.

Notes

1 Also referred to as "The Washington Consensus".

2 In the United States lending of non bank financial intermediaries to the private sector is the equivalent of nearly 70% of GDP. In most Latin American Countries, it is less than one percent of GDP.

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