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Unshackling the Private Sector

A Latin American Story

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UNSHACKLING THE PRIVATE SECTOR

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Contents

Text Boxes

Text Tables

Text Figures

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 development 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.

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 international 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 overzealous 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 otherwise 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.