Convidamos V.Sa. para participar do Seminário de Pesquisa Econômica II (2ª parte) a realizar-se na próxima 5ª feira:

DATA: 25/11/93  
HORÁRIO: 15:30h  
LOCAL: Sala 1021  
TEMA: "PRIVATE SECTOR DEVELOPMENT AND PROPERTY RIGHTS IN LATIN AMERICA", pelo Prof. José Luiz Carvalho (EPGE/FGV).


Prof. Fernando de Holanda Barbosa  
e Prof. Gregório Lowe Stukart  
Coordenadores de Seminários de Pesquisas/EPGE
The great revolution of modern society was to recognize that freedom is highly valued by man and therefore should be preserved and promoted. Contrary to the Medieval society, when man values for his role in the society, modern society emerged from freedom valuation bringing with it a never seen prosperity but also risks and uncertainties. According, a modern society is organized by free men under a "social contract" where all are equally submitted to the rules of Law. The political power is managed under a democratic process and the concentration of power by the state is subject to rules (constitution) which aim is to protect individual freedom and rights.

From this same liberal root two alternatives for economic organization were developed to manage the conflict of interest among members of a society subject to scarcity: capitalism and socialism. Under capitalism private property rights is essential to preserve freedom and to promote economic efficiency. Contrariwise, socialism plead for common property of productive resources to promote a fair distribution of output among members of a society. The recent events in Soviet Union and in East Europe are the death

(*) Director of Instituto de Ciências Econômicas e Gestão - IEG/USU, Professor of Economics at Universidade Santa Ursula and Escola de Pós-Graduação em Economia - EPGE/FGV.
certificate of a romantic ordering of production in a human society. The socialist effort to reduce risks and uncertainties brought about by the new social order (modern society) drove man back to the medieval organization where man was valued for his role in the social engine and ideology provided a less riskier future.

The purpose of this paper is to raise some issues related to the private sector development and property rights in Latin America. By dealing with Latin America as a unit we will look for common regularities and therefore will miss important aspects of individual country cases. The historical background is founded in Latin America history books and in some specific studies for some countries.\(^{(1)}\)

The economic growth registered by Latin America since independence to 1950 has been attributed to her abundant natural resources. During this period Latin America per capita rate of growth kept phase with Europe and United States. From 1950 to the first petroleum price shock Latin America continue to perform well with a per capita income growth higher than the previous period. Nonetheless, relative to other regions Latin America lost phase. The situation is worsened from mid 1970's on, either with respect to her previous level of income per capita and more drastically so if compared to other regions.\(^{(2)}\)

Several explanations for the relative decline of per capita income have been advanced and in one way or the other boils down to excessive government providing inefficiently much less of public goods and much more of private goods; much more of regulations and much less of stable rules; much more of government power concentration and much less freedom.

In discussing the institutional obstacles to Latin American growth, Boner-Brunetti-Weder (1992) state:

"We will show in this paper that although the behavior of Latin American peoples differs widely, it is a mistake to take recourse to cultural factors (such as race and religion) too quickly. Rather we think that the institutional environment explains these behavioral characteristics quite well-and within an economic framework." p.9

\(^{(1)}\) Except when is required, historical references will be minimized along this paper. For general information on Latin America political and economic history see for example Anderson (1967) and Johnson (1958).\(^{(2)}\) Based on Boner-Brunetti-Weder (1992).
We do agree with the authors with respect to the importance of the institutional arrangements in explaining what is going on in Latin America. We also agree that race and religion play a marginal role in this case but this is not true for all cultural aspects. Institutions are in the author's words: "We define institutions as rules of the game. Institutions are sets of rules that govern the behavioral relationship among individuals or groups." (p.13). Therefore we cannot separate the values and the ethics of a society from the institutions that are born under these values and ethics. Laws on their authentic meaning are society mores.

It is our understanding that the Iberian Culture inherited by Latin America is a determinant factor in the persistent refusal of Latin American societies to enter modernity. Far from societies of free individuals Latin American countries maintained after their independence the same state organization implemented by Iberian Peninsula during colonial times. The role of the State in Latin America has been negative to the development of a sound private sector because it fails to secure contracts. In fact, the heterodox experiments from mid 1980's on (Plano Astral in Argentina, Plano Cruzado in Brazil) are examples of how a government should not act if the role of the State in a modern society is understood by officials. Latin American governments have been producing such a high degree of uncertainties that even those entrepreneurs benefited by their policies complain about frequent public policies shifts.⁴

Courts are expensive and time consuming. In some countries results are unpredictable due to corruption. In others judge bias, specially in favor of worker's demand, discredit justice. Seldom in Latin America courts act as countervailing power to the legislative or to the executive. We know of one recent case in Brazil. The Supreme Federal Court pronounced unconstitutional a tax on financial transactions and transfers submitted by the executive and approved by the Congress.

We will develop our argument as follows. In the next section we elaborate on the concept of property rights and its importance for social organization, in particular for establishing the division of labor between the State and the private sector. In the following section we complement our discussion on property rights by considering how this institution affects economic efficiency and consequently economic development. In the fourth section we raise the hypothesis that by refusing to enter modernity Latin

⁴ See for example the World Bank Private Sector Assessment for Uruguay and Peru. For references on studies for Guatemala, Chile, Ecuador, Colombia and Bolivia see Bomer - Brunetti - Weder (1992).
America refuses to accept the importance of property rights. Chile is the exception to confirm the rule. In the last section we use the case of Chile and Peru to illustrate different ways Latin American countries can take to modernity. We end up with some remarks about the role of local intelligentsia in changing current mentality.

2- PROPERTY RIGHTS AND SOCIAL ORGANIZATION

By living in society, man, voluntarily, gives up part of his freedom to promote a social order. In this way society can only be organized by the acceptance by all to have their actions equally submitted to the Rule of Law. As a result of communal acceptance, the Rule of Law preserves each one's rights and freedom although limiting one's action. Three fundamental individual rights have to be preserved under the Rule of Law: the right of existence, the right to pursue, freely, one's own happiness and the right to property.

Modern society, constituted by free individuals, is a recognition that man is free by nature and therefore the right of existence and freedom are self explanatory. The fundamental characteristic of property rights in a free society requires some explanation. This is so due to the frequent aggression to this fundamental right and its role in promoting efficient use of scarce resources. Although human life and freedom are also frequently under attack, there is no ideology against these two fundamental rights. This is not the case of property rights that in many occasions are seen as a source of wealth inequalities and therefore unfair.

Posner (1972) suggests three requirements for an efficient system of property rights: universality, exclusiveness and transferability. Property rights should be universal in the sense that all resources should be owned by someone, except when no issue of efficiency arises. Exclusiveness implies that no one but the owner of the resource can command its use. Transferability is required for allocative and over time efficiency. In this later respect, property rights must be perceived to be permanent.

(1) We are not interested in distinguishing here the nature of this social order. We are just emphasizing the importance of the rule of law. For a discussion on the nature of this order as well as the difference between law and command see Hayek (1978).
Following Alchian (1977) we consider property rights as the protection a particular individual has against other people's choosing against his/her will a possible use of resources accepted to be his/hers. This protection is to the physical attributes of the resource and not to its market and or psychological value. Thus, changes in market value of one's property, that result from other individual actions, that don't alter its physical attributes, do not constitute an aggression to one's rights.

To appreciate the extension of this institution it is instructive to consider exchange as a mutual transfer of rights. Also, there are costs associated to the definition, protection and maintenance of property rights. In this way, property rights are never complete, are not absolute and can be changed by individual's actions (a sale is a property rights transfer). As the cost of defining property rises to a prohibitive level no transaction may occur. Besides, society has to provide a system to recognize and enforce rights (laws, police and courts). This system has a cost and its existence does not imply that individuals will not have to direct efforts to protect their rights against other people's capture attempts.\(^1\)

Societies are organized under a State for the same basic reason business are conducted by firms: to reduce transaction costs. Thus, the State has a defined role in a social organization. In a society where freedom is to be preserved is the function of the State to provide conditions for an harmonic life under the Rule of Law and for the development of economic activities under free market. A well defined system of property rights is required for both goals. The absence of a well defined system of property rights will exarcebate conflicts over the use of resources, reducing the economic efficiency of the market or making impossible its development in some cases.

A State is an institution, that is, a set of rules to reduce transaction costs as well as a market or a firm. Nonetheless, in the modern society the State owns property. In Latin America property owned by the State (all administrative levels) is substantial. Even in the United States of America this is so: the Union is the larger land owner in the US. This is very important since there are substantial differences in the use of resources according to who owns them.

\(^1\) For a detailed discussion on property rights see Barzel (1989).
Property can be private, publicly or State owned. Private property, as we will explain in the next section, offers the greatest flexibility in using scarce resources, as long as property rights can be freely divided, combined, exchanged and traded. Private property can refer to an individual owner or to a group of individuals as in the case of clubs, corporations or cooperatives. Publicly owned property refers to resources subject to common use. In this case no one can be excluded from using the resource and no one can transfer the rights associated to a common property. These are the main sources of problems in using common properties such as streets. State owned property is an odd way of holding property. Managed by the State bureaucracy, State property is in general used to benefit specific groups at the expenses of tax payers. Common property and State property are growing everywhere due to deliberate action of small groups seeking for rents or in order to reduce risks associated to private property.

3- PROPERTY RIGHTS AND ECONOMIC EFFICIENCY

The image of the "invisible hand" elaborated by Adam Smith is well known. The economic spontaneous order imposed by the free market fitted as a glove to the emerging modern society viewed as a contract among free individuals. Nonetheless, behind the invisible hand of the market, there are other institutions not so "invisible" but hardly considered as a "sine qua non" requirement for Smith proposition. Social mores and Common Law provide society with the necessary order to make market efficient. Among these institutions, property rights emerge as a must. How could one produce and supply wheat, moved by his own interests, if by crop time anyone could come and collect the product of his work?

The conditions under which free market promotes maximum welfare in a society are well known to economists no matter their ideological preferences. Most unfortunately very few stress the importance of property rights. Less so common people, in particular in third world countries and in special in Latin America where not only property rights but also human rights (existence and freedom) are frequently disrespected. Aggressions to property rights in these countries frequently comes from State action. Just the State, the institution created to preserve the fundamental rights and the Rule of Law! Even in the United States where the notion of property rights is so strong among her
people, very few citizens recognize the increasing reduction on their rights by the action of the State.

In a society organized under the Rule of Law, there will be no market if property rights do not exist. Oscar Lange, recognizing the superiority of market solution to economic problems tried through a fallacious argument, to show that a market solution could be attainable in a society where productive resources were common property managed by a planning office. His arguments did not resist to critiques and the empirical evidence has definitely shown he was wrong. Private property rights is the visible counterpart of the "invisible hand".

Most governmental intervention in the market has been justified by the so called market failure. Market failures would emerge by indivisibility, public goods, common properties and externalities. It is also common to consider as market failure, market imperfections generated by the existence of costs to acquire information. Thus adverse selection and moral hazard are some times considered as market failures. We prefer to consider them as imperfections in the information market and therefore they will be not considered in this discussion.

Since Edgeworth, the existence of indivisibility has been considered as an impediment to free market. The distribution of water in a city is a common example of how indivisibility (we cannot take water to a point B without passing the pipe through A) prevent the development of a free market. The solution to these cases is the public authority to concede what economists call natural monopoly to a supplier of the service or good. To prevent the supplier from exploring this monopoly power, the public authority controls the price to be charged to consumers. This is a widespread procedure in the case of the services associated to utilities.

Occasionally technological change eliminate the indivisibility and therefore there is no argument left to justify natural monopoly solution. This is the case of telecommunication through satellite. The possibility of renting the satellite services for communication eliminate the cable infrastructure investment indivisibility in interurban or international telephone services. This happens in US but public authorities in Latin America insist in maintaining state monopoly in this service. Even urban telephone

(1) For a summary and a critique to Lange's argument see Nutter (1968).
(2) For a discussion of theses cases as imperfections in the information market, see Kreps (1990).
services might lose their monopoly condition with the advent of cellular telephone. Thus, market failure associated to indivisibility can be eliminated by new technology. When this new technology is not available, natural monopoly arrangements, provided the public authority does not transform this economic problem into a political one, will permit society to enjoy consuming the corresponding service under a long run marginal cost equal to the price paid by consumers.

Public goods, for which the consumption by a person does not reduce the consumption of any other, is also identified as a market failure. Once the good is produced, any consumer will have access to it without payment or reducing any other consumer possibility of having the good. But, someone has to pay for the product to be produced. Therefore there is implicit here a financing problem. Usually public goods when supplied by public authorities have their production financed by general taxes since no citizen can be excluded from having access to the good. This financial problem seems to be important only when the public good is produced by the government or when the absence of this good will impose a cost to the society much higher than the cost of having taxes to finance its production. Note that taxes are confiscation of resources produced by private owned resources. Also, the public authority action with respect to public goods can be restricted to promote incentives to finance their production. In this way the government does not need to produce the public good for the society to enjoy it.

In general, in a society of free individual scientific knowledge is produced by the private sector. The government might allocate funds to promote science development. It can also provide incentives, through the tax system, to scientific research. Anyhow the scientific knowledge produced by private or public sectors is a public good. Music once composed and disseminated is also a public good. While in the case of scientific knowledge most people argue in favor of public authority incentives, very few, except for the composers, will argue in favor of music. This is so due to the importance of the externalities associated to the first case. Nonetheless, scientific knowledge produced in a country can be acquired by any citizen in any country at a very low cost (books, journals) as compared to the cost of producing the new knowledge.

A complete different situation emerges in the case of inventions associated to traded goods. In these cases, the promotion of new inventions incorporated in traded goods, is more efficient by protecting the property rights of the inventor by a system of
patents. By protecting the inventor's property rights the patent system guarantees a market for inventions.

Thus, the market failure associated to public goods is a matter of financing the public good production. The government in general does not need to produce the public goods but only promote its financing. In the case of invention (and others such as industrial design) market function is preserved by defining and enforcing a patent system to preserve property rights.

Common property market failure results from the absence of private property. Air and water pollution or traffic jam are examples of market failure in common property cases. Note that the origin of the failure is the non existence of private property or an improper definition of property rights. In first case, who should be excluded from enjoying the common property? In second how can one protect his property from the externality produced by others as they use the common property? In both cases, two different situations might occur in solving the conflicts: transaction costs are low or large.

Efficient management of common property is a relatively simple task when transaction costs in characterizing property rights are low. This is the case for commons in a small community or in condominiums. In the latter case, property rights over the commons are well defined by a set of rules that the participants voluntarily accept as they move in. Fishery in a lake can be a permanent activity by restricting fishery activity by licensing and fishing period.

When transaction costs are large governmental regulations are frequently used to prevent misuse of the common property. The problem with governmental regulations is that it transforms an economic problem into a political problem. In this respect society always loose since the political system provides worse solutions to economic problems as compared to market solution. But since the market is not able, either, to solve the problem of commons or of externalities, something has to be done to prevent conflicts in the use of commons. Regulation is a way out but should be handled with care.

Regulations are a transitory solution and are subject to the action of interested groups. Since there is no formal market for regulations, restrictions on lobby activities have to be imposed to prevent groups to produce legal constraints on others for
their own benefit. Regulations are transitory solution because technological progress might reduce transaction costs in such way to make possible to legally input responsibility to the owners of the source of the externality. In this sense, property rights have to be seen as a dynamic concept adjustable to the circumstances. Note that prior the invention of barb wire the cost of identifying one's private property in American West was very high and therefore common pastures were usual although inefficient. [See Anderson-Leal (1991)].

Regulations are followed by the creation of a bureaucratic body highly interested in preserving their political power. Most frequently discretionary powers are conceded to these bureaucrats favoring corruption. In other cases, regulations impose such a high transaction cost that social activities are developed by-passing these rules. This has been the case of the informal economic activities developed all over Latin America.\(^{(1)}\)

Once economic regulations get started bureaucracy will actively promote more regulations on their own interest. Interest groups will joint bureaucrats in this regulatory effort in order to drive regulations to promote their welfare.\(^{(2)}\) Soon people will realize that rent seeking through regulations has a high pay off and a market for regulations will be established. At this stage, moral values in the society will be seriously threatened. We should not underestimate the disruptive power of regulations. A trip to some third world countries can easily prove that situations such as this are no chimeras.

Thus, the administration of common properties as well of externalities might require regulations as long as the characterization of property rights cannot be made at bearable transaction costs. Legal constraints are required to impede the development of a regulations market. Regulations, although temporarily required to by-pass some market failure, should be conceived in such way to prevent any kind of discretionary power to bureaucrats.

It is clear that the absence of private property will prevent people from enjoying the benefits from free market. It is also clear that market failures are associated to the existence of high costs in the characterization of some private property rights. Therefore it is in the society interest to develop technology to characterize property rights

\(^{(1)}\) See for example De Soto (1986) and Burger (1991).
\(^{(2)}\) On the economic of regulation see for example Stigler (1971), Peitzman (1992).
to prevent significant market failures.\(^{(3)}\) It is also in the society interest to define an efficient system of property rights (in Posner sense) as well as to maintain mechanisms to protect property rights and settle individual conflicts.

Since free market produces, under some circumstances, the highest welfare, as long as property rights are well defined, we should expect that societies where property are private owned and free markets are well developed will experience higher levels of prosperity as compare to others where private property does not exist or is subject to institutional instabilities. A set of important empirical evidences along this line is presented by Waters (1987): "Every success cannot be a special case, every failure cannot be due to random and external events. Economies in the Third World can be grouped into those that are market oriented and those that are more regulated and centrally controlled. The more market-driven economies have consistently outperformed the others." (p.103)

4- PROPERTY RIGHTS IN LATIN AMERICA

Today Latin America is plagued with excess regulations and State intervention, high inflation, political instability and social arrangements that endanger individual fundamental rights. Chile is probably the exception to confirm the rule. Nonetheless, Latin America is said to be politically organized as a democracy and (except Cuba) economically as capitalism. Far from this view, Latin America lacks the principal ingredients for democracy and capitalism, a system that defines and enforces properly the individual fundamental rights.

To understand Latin America current situation it is instructive to review briefly how these societies were formed and how their Iberian inheritance played a decisive role in producing the Latin America culture. Discovered and colonized by Spain and Portugal (Iberian Peninsula countries) that for quite some time, during the colonization

\(^{(3)}\) Property rights are associated to technology in two ways. Technology might chance the nature of property producing losses or gains to its owner. On the other hand, technology can provide a low cost characterization of property and therefore increasing its value and promoting free market.
period, were unified under a unique crown, all countries in Latin America inherited the Iberian culture.

By the time of the great discoveries and along the colonization period (XVI through XVIII centuries) Spanish Crown revenue derived from taxes as for any other crown. Nonetheless, the most important source of revenue for the Spanish Crown was the one collected form shepherd's guild (Mesta). Tax collection on shepherds depends on their possibility of making a profit out of their trade. To guarantee shepherds grazing land the Crown conceded them exclusive rights to drive their sheep across Spain. Other measures such as the imposition of a price ceiling on wheat as well as a freeze on land rent were enacted by the Crown to increase tax procedures to face increasing expenditures. The consequences to agriculture were well analyzed by North and Thomas (1973) and summarized as follows:

"In the case of agriculture, the decrees favoring the Mesta effectively thwarted the development of efficient property rights in land. The royal order of 1480, for example, ordered evacuation of enclosures set up by farmers on communal land; the Edict of 1489 redrew (widened) the boundaries of Granada's sheepwalks; the Edict of 1491 banned enclosures in Granada; and the land lease law of 1401 in effect permitted sheep to graze anywhere that they had at any time previously occupied for a few months and allow their owners to pay in perpetuity the original rental fee; if they had grazed without the owner's knowledge they paid no rent. The development of arable agriculture was further weakened when a price ceiling was imposed on wheat in 1539. In a century of inflation the fixed rent on land and the ceiling price on wheat had predictable consequences in the celebrated depopulation of the countryside and even recurrent local famines. There were simply few incentives to engage in arable agriculture and much less to improve it." (p.130)
As tax revenue increased, expenditures increased faster but Spanish Crown did not cut expenditures given her goal to expand the empire. Borrowing was the way out once taxing limit was reached. It is reported by North-Thomas (1973, p. 129) that by 1562 about 25% of tax revenue was to be used in interest payments on crown debt. Nonetheless increasing debt could not stop the crown from her main goal and non orthodox procedures were put in practice:

"As the Crown's financial difficulties increased, seizure, confiscation, or the unilateral alteration of contracts were recurrent phenomena which ultimately affected every group engaged in commerce or industry as well as agriculture." [North-Thomas (1973), p.131].

North-Thomas (1973) contrast the stagnation of France and the decline of Spain with prosperity of Netherlands and England. In the first case the crowns fail to provide the basic functions of a government: protection and justice in return for tax revenue. In our modern language the crowns of those first countries fail to establish and enforce the Rule of Law to preserve the fundamental individual rights. In particular they act above the Law and intentionally deprived society from property rights. In the second case the crowns provided society with an institutional and organizational setting that favored private property including on intellectual production in England. But these outcomes do not result from pure chance. France and Spanish crowns maintain their power by bribing groups with concessions, monopolies and protection. This way was ruled out in Holland by an oligarchy of merchants that soon discovered the benefits of the free market and the necessity of a private property system to its functioning. The ascendancy of parliament over the Crown impeded England to engage in a expansionist policy adopted by France and Spain. The Crown was circumscribed by the Common Law and tax increases were vetoed by the parliament.

Iberian governmental practices were implemented in Latin America under an absolutist system and the political-economic system at the colonies was an integral part of mother country. Latin America independence from Iberian Crowns started around 1820. All new countries except Brazil and Mexico, this latter one for a short period of
time, adopted the modern state paradigm crystallized by United States and France. Despite all excitement and the joy of becoming independent no profound changes were to occur in Latin America. It seems that until today she refuses to engage in the modern society road of uncertainty and risks but of freedom and property.

The political-economic system of the newly countries was the same of the colonies. Local government replaced the Crown. The system of *encomiendas* or *repartimientos* was replaced by the *latifundia* or great estate. The main economic activity continue to be production and export of primary goods. In most countries one product dominated the economic scene.

The Latin America elite continued to enjoy the proceedings of her exports under a system of free convertibility of currencies; sending their children to study abroad (specially in France and the United States), much more interested in European new developments than building a nation. Their standard of living and values were Europeans and the low tariffs imposed on imports allow them to enjoy the same products and consumer novelties as Europeans and North Americans. Their interest in the country were provincial, highly associated to the region where their economic activities were developed. This contributed for the development of an elite without a sense of nation-state.(1)

One might argue that the evidences are contrary to the above explanation since the constitutions of these new countries reflected the concept of a modern state. Property rights are explicitly defined as well as the principal role of the state of providing and enforcing the Rule of Law. It is our view that it is a mistake to read Latin America constitutions as such. As Guissarri (1989), in a different context, puts it, constitution was viewed as an agreement that allows groups to participate in a good business.(2) This concept certainly is not restricted to Argentina. Since her independence, Latin America promulgated 255 new constitutions up until early 1980’s. This corresponds to an average of 10 constitutions per country that last on average about 16 years each.(3) Recently a group of businessmen in São Paulo, formally suggested that in reviewing the actual Brazilian constitution, the congress should introduce a proviso establishing a constitutional revision every five years! There is no doubt businessmen will invest time and resources to

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(1) See for examples Anderson (1967).
(2) Guissarri discusses here the relationship between constitution and informal activities in Argentina. His analysis starts from the "constitutional agreement of 1853".
(3) Rosenn (1984) p.8. It is important to note that at each new constitutional revisions more and more positive rights are granted to groups and the role of the state in the society is consistently enlarged.
approve regulations on their benefit. If these regulations are in the constitution, the expected gains are higher since the loss of the corresponding benefits are much more difficult to occur since it will require a change in the constitution.

Except for Chile all other countries organized as republic had their first government headed by military. After some period of state organization and some armed conflicts, internally and among neighbors, the military became an organization in quest for a role. Thus they proclaim themselves and made it clear in the constitutions that they are the guardians for the constitution. This might explain why military coups are so frequent in Latin America as well as changing constitution.

By early 1900's the colonial exporting model begins to show its weakness. Refusing to enter modernity Latin American elite press government to provide the means for increasing or preventing their rents from dropping. Investments in infrastructure are required but the state cannot collect enough taxes to realize the required investments. Also, human capital expertise is lacking and Latin American Countries compete with other regions to attract foreign capital. To promote direct foreign investment local governments offer grants in land, liberal leases to subsoil rights, guarantee rate of return on investments, cheap credit among other benefits. Later on, along late 1950's through the early 1970's, foreign capital would be discriminated and in some cases would have their business expropriated by the State. After the 1982 international financial crisis, borrowing abroad was not possible to Latin America and given her large foreign debt, direct foreign investment was once more favored by several countries.

These events demonstrate how unstable politically and economically has been Latin America. In some sense, this instability results from the refusal to enter Modern Era. Latin America gravitate around Modernity, absorbing the main issues from the Modern and developed world but refuses to take the risks of modernity in order to collect their benefits. Latin America, as many other areas in the globe is structured as a medieval society disguised as modern by their modern institutions (property rights, individual rights markets democratic political process), organization (business firms, capitalism, government) and consumption goods (automobiles, cellular telephone, TV, micro-computers). The refusal to modernize and the mimetic behavior of her elite can be identified in the following examples.
The anarco-syndicalism of the developed world, in special in Europe, of early 1920's was absorbed by Latin America intelligentsia. The inequalities produced by the industrial revolution gave birth to the Maxism-Leninism "theory" of class cleavage. The situation in Latin America was quite different. The observed inequalities resulted from economic activity concentration, regionally and in the hands of small groups, protected from competition by the State (in several cases dictators). The arguments used against inequalities were imported from the European class cleavage conflict and there was an implicit refusal to identify domestic problems favoring the proletariat cause. Corruption and power concentration, either politically and economically, were almost completely disregarded by Latin America elite.

The 1930 world recession produced in Latin America more economic growth than recession but not without a cost. World trade was reduced and an spontaneous import substitution industrialization process started. Of course, exporting activities suffered with the decline in the demand for their products and this event exposed the fragility of Latin America political-economic arrangement. Rents were redistributed from exporting sectors to the import substitution industries. Most of these new opportunities were explored by the elite that directed their economic resources, as well as their political power, to explore these new opportunities. To preserve their economic rent, competition was impeded by state regulations. The New Deal argument was extensively used to justify governmental economic activities on behalf of the starting industry. Fascism had a great impact on local authorities and social security legislation provided individuals with certainties impossible to be sustained by the State. Once again imported "theories" and arguments were used out of context.

The cost to be paid by "isolating" Latin America from the World crisis was an increasing participation of the State in economic activity and an increase in protection, now expanded to the new born industry. The emergence of fascist practice revitalized corporativism expanding it to the labor force elite protected by regulations in truly medieval guilds. A strong nationalist movement emerged to consolidate domestic industry protection and state paternalism became explicit to all through the implementation of a governmental managed social security system. Apparently property right aggression, through price controls, taxation, increasing inflation and protection, were not identified by the elite that benefited in the short run from the State action nor by the people, ignorant and happy with the state protection.
This process would in general continue in a slow pace, with a different dynamics accordingly country conditions, up until the end of World War II. As domestic interest groups diversify the demands over the State, government enlarge its role in society promoting reforms in favor of the new political groups but preserving the previous exporting commodity model. Inflation is used by the government to satisfy the increasing demand for protection. State enterprises became a natural way to provide private sector with cheap inputs, regulations continuously produce benefits to small groups, promote corruption and a steady growth of bureaucracy. Industrialization through import substitution is deliberated promoted by the government, increasing inflation, regulations bureaucracy and corruption.

More recently after the fall of Berlin Wall and the dismantling of the Soviet Union, a "new fashion" struck Latin America government. The success of the neoliberalism in Mrs. Thatcher’s England and Mr. Reagan’s US brought about a wave of deregulation and privatization that reached the majority of Latin America Countries when their States were effectively broken. These reforms in Latin America are not a result of consensus. They do not emerge by the belief that less State and a stronger private sector in a market economy will promote a better welfare for all. The exception once more is Chile that implemented these reforms gradually from early 1980's.

Reading Latin America history in this way, and we understand that there are alternatives, it becomes clear that Latin America refuses modernity due to the uncertainties and risks associated to Modern Society. Property rights in Latin America have never been well understood as a sine qua non requirement for market economy and economic efficiency. Governmental protection has been the goal of the large majority of private sector. The development of personal relationship with high officials is the actual version of being the King’s friend. If this is the rule of the game, private sector very quickly absorbs the information to survive and prosper. Resources are direct to promote regulations and protection feeding bureaucracy and corruption as well as increasing the role of the State. For those that have no access to privileges, life is very difficult and a large fraction of these "unfortunate" are driven to informal activities.

The informal sector in Latin America is not as De Soto (1986) suggests a market solution for the excess of regulations and governmental intervention.\(^{(1)}\) It is in

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\(^{(1)}\) In countries such as Brazil and Argentina in the 1980’s informal sector corresponds to about 50% and 60% of measured GDP according to Lima (1985) and Guissarri (1989) respectively.
fact an attempt to survive and prosper but at a very high cost to the society. For the informal economic agent, in the short run, the benefits of informality are much higher than the costs of becoming formal. In a longer run, as the Peru example dramatizes it with an uncommon strength, as the informal activities expand, the basic institutions that preserve the Rule of Law are destroyed and the gains from living in a society are substantially reduced. As in the case of Peru it might become unbearable. In this way, the informal sector works as an "invisible hand" plowing future disorder and social chaos.

5- THE WAYS TO MODERNITY

During the Roman Empire it was public wisdom that "all roads lead to Rome". Today this expression means that there are many ways of reaching the same result. We do not dispute that this is true for Latin America to enter Modernity. But we will consider two completely different ways based on the experience of two maybe extreme cases: Chile and Peru. Heiresses of the same Iberian Culture they had been treated differently by their Mother Country. Lima was chosen as the metropolis of the Spaniard America while Chile remained as a simple province. The difference goes further back, prior the arrival of the conquistadores. Peru was the Inca Country, the most advanced civilization in the entire Americas. Unfortunately their organization and progress were responsible for their almost complete destruction. Peru's independence came about easily because Spain was fighting against the independence of Chile, Colombia and Argentina. Nonetheless, after independence of Peru, her roy ways disappear.

Ironically, Peru and Chile fought a war in 1879 over some territories rich of nitrate deposits. Peru lost the war and the territories.(1) Since 1875 the Chilean economy, based on wheat exports, was suffering from the surge of new producing areas in North and South America, Russia and Australia. These new competitors, much more productive as compared to Chile, drove her out of the market. The conquest of the rich nitrate deposits would direct Chile to mineral exploration and exports. Peru on the other hand entered the war under the first civilian president since her independence in 1821 and during the four years of War Peru had seven presidents. The Chilean winning military

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(1) The Pacific War lasted until 1883 and Peru was allied to Bolivia against Chile over the territory dispute.
gained prestige and respect but did not take over local government while the losing Peruvians occupied the government until 1895, after a period of political turmoil that ended in a popular revolt and the election of Peru's second civilian President. Since the beginning these two countries chose particular roads that in many aspects are equal to those selected by any other Latin America Country. Here we will stress the particularities that made Chile and Peru, two polar examples in Latin America.

CHILE

The year of 1883 is not only the end of a victorious war for Chile. A new constitution was approved, making the Roman Catholic Church the State Church. This new status gave the Catholic Church not only political power but also, some monopolies (marriage, death and birth certificates, cemeteries) that would not last long. Waves in favor and against the Catholic Church are frequent in the history of Chile. It was only in the 1925 constitution that the Church was separated from the State. Nonetheless a stronger and lasting lobby would also emerge in 1883 with the foundation of SOFOFA - Sociedad de Fomento Fabril, an industrial association created to lobby for protection. The strong influence of economic lobbies would be reduced only after the reforms of 1982, almost a century later!

After World War I industrialization produced urban concentration and a steady growth of a middle class which started to play an important political role. Middle class political action concentrated on imposing some priorities on public policies specially those referring to education and social welfare. Largely composed by professionals (lawyers, professors, medical doctors) middle class strongly contributed to create in Chile a general recognition of the importance of personal liberties. If valuation of personal liberties favored private sector and property rights, it also favored the development of communist party action. Since liberties and not freedom was the main value, Chile became subject to some radical group actions.

By early 1920's Chile had a large proletariat, for Latin America standards, favored in its political action by the urbanization and the consequent break of the family as a political unit. Only Uruguay could be compared to Chile in this respect at that moment in time. The permissiveness of the personal liberties concept and the fast urbanization
imposed some costs to Chile. Electoral liberty meant "liberty to indulge in fraud and bribery" [Johnson (1958 p. 76)]. Workers considered their right to sell their votes. This would contribute to discredit the democratic process.

Fast urbanization drove workers to live around Santiago in promiscuous and insanitary quarters. Infant mortality rate became the highest among the nations of the Western World. If there was a place in Latin America where the class struggle identified by the new ideology would have any meaning, this place was Santiago. In frequent contact with European leaders, work leaders in Chile were strongly influenced by them. Labor movements developed independently from the State contrary to what would happen later on in Argentina, Brazil and Mexico. Also, labor movements did not restrict their action to labor demands. They played an important political role and favor the growth of the personal liberties value. Their action were decisive in the congressional elections of 1918. This political action was not developed in detriment of labor demands. In 1924 any enterprise in Chile had to have at least 75% of its while-collar employees of Chilean nationality. This percentage was raised to 85% in the 1930’s.

The cost of abusing on personal liberties came through a military dictatorship from 1924 to 1931. Carlos Ibáñez, that would be elected president in 1952, was forced to abdicate by middle class political pressure. The main complaint against the dictatorship were the frequent aggression on individual liberties. In Chile, given the strong valuation placed on individual liberties, there was little room for Caudillos and political personalism so common in Latin America even today.

The importance of middle class and the cultivation of individual liberties as a value are, as we understand, the particular elements that made possible modernity in Chile. Nonetheless, the passport to modernity would be issued only when these individual liberties were threatened by socialism.

Subsidies, protection and a strong xenophobia directed governmental policies in Chile despite the differences in government administrations: military, socialists or central-right. During the Cold War, Chile received economic and technical support from US as several other countries in Latin America. Despite the approval in 1948 of the Defense of Democracy Law that made Communist Party illegal, xenophobia and socialism were growing in Chile. The socialism bias reached a peak during Allende government. Elected with 37% of the votes with a program to implement socialism in Chile, Allende
government expropriate large firms, farms and private banks. A large program of income distribution accelerated inflation and governmental deficit. This program produced industrial stagnation, smaller farm output and a military coup in September 1973.

Socialism was growing in Chile during Frei government (1964-70). The middle class intelligentsia identified in the agrarian reform Law and in the increasing welfare state legislation a potential danger to individual liberties. More than that, an elite, that resulted from several years of consistent investment in human capital, concentrated at the Catholic University at Santiago, identified these as a threat to freedom, private property and market economy as well as to democracy. As reported by Harberger (1993) this group was very active politically and engaged in the 1970 electoral dispute supporting Jorge Allessandri.

The election of Salvador Allende did not dismantle the Catholic University group: "As the Chilean economy went from bad to worse, the group was reconstituted, and started to update its 1970 diagnosis. Their analysis and recommendations were summarized in a brief document which they called El Ladrillo." Harberger (1993) continues his considerations about the importance of this group for recent transformations in Chile:

"I do not think it is an exaggeration to say that the studies and debates leading up to El Ladrillo played for the subsequent revolution in Chilean economic policy a role not unlike that of the Federal Papers in shaping the constitutional framework of the United States". [Harberger (1993) p.345].

As in the case of Netherlands and England men of convictions played the important role in transforming Chile. The existence of a middle class that value individual liberties, established since the beginning of this Century, was the amalgam that made possible the development of the Catholic University group. Their convictions were so well nourished and developed that despite the political system be organized under a military dictatorship, they could lead Chile to a modern society, where freedom and private property favored the development of a strong private sector and therefore
prosperity. Transformation through human capital was the natural way to modernity in Chile.

PERU

From her independence in 1821 until 1990 elections, Peru had 80 presidents of which 53 were members of the military. This dramatic record summarizes the permanent political turmoil in Peru that prevented the establishment of modern institutions to manage social conflicts.

Successive short governments contributed to an endemic budget deficit with tax burden concentrated on imports and exports. Governmental public works projects, when undertaken, were financed by borrowing abroad. The combination of these two characteristics of Peruvian public policy produced a permanent inflationary process subject to cycles associated to international prices. The economic conditions strongly affected political stability. Stable Governments are associated to favorable world price conditions for Peruvian exports (eg. 1895-1919, Korean War period).

Government failure in providing public goods and services, in special a legal system (the rule of Law), is the main responsible factor for the high frequency of Military Coups that Peru has been subject to. As economic conditions deteriorate and social conflicts grew, the way out in Peru has been a coup. The new government would try the same remedies but in different dosages with about the same results. The ingredients have been nationalism and populism. Very rarely some attempts to promote market economy occurred but even in these occasions the low level of people's education and the strong limitations imposed by a precarious judicial system aborted the attempt or concentrated opportunities to few. This contributed to a strong socialist bias in Peruvian society that would only be neutralized, partially, by the determined action of a group concentrated at the Instituto Libertad y Democracia. Founded in May, 1980 under liberal principles ILD has been the major resistance in favor of the three fundamental rights (existence, freedom and property), of a market economy and a strong private sector.

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(1) This record implies an average of 2 years and 45 days for each president and that 2 out of 3 presidents were members of the military. For a brief summary of Peru history see World Bank (Report 12096-PE, 1993).
(2) Favorable exporting prices increase tax revenues and also permitted servicing foreign debt and therefore maintaining Peru in the international financial market.
Identifying the lack of property title and therefore the enforcement of property rights as a major impediment to the development of a strong private sector, ILD has, since Alain García's government, invested resources to register property. This effort continues until today under an agreement with Peruvian Government. The main reason for having a private institute doing property registration is the total failure of the Government in providing this service as well as lack of confidence people place in public institutions in Peru.

ILD has been producing research and public services such as the one above mentioned. Playing a decisive educational role in the Peruvian society ILD was responsible for the liberal wave that struck the country in the 1990 elections. The two candidates in the elections second round presented liberal proposals. No doubt the recent events in East Europe and in the former Soviet Union contributed to the upsurge of liberal ideas, as well as the resounding failure of the socialist experiment under Alain García. Nonetheless, the continuous and persistent work of ILD staff, most of the time under life endanger situations, paved the way for this outcome. Only men of convictions could continuously work under the circumstances faced by ILD in the 1980's:

i- constantly threatened by the actions of a terrorist group, Sendero Luminoso whose principal goal was to destroy actual Peruvian society to build a new one based on Maoism. Due to their action in favor of the rule of Law as well as by registering specially rural properties ILD raised against it and its staff the anger of terrorists and narco-traffic groups.

ii- besides the country situation was despairing:
"Widespread strikes from the left frequently paralyzed state services. Output plunged, inflation soared, real wages declined dramatically and the fabric that binds society began to tear. This phenomenon has been described as desgobierno, the unraveling of government."...
"Thus the García presidency culminated in the virtual collapse of Peruvian economy. Two important points need to be made, however. First, this created

(3) For a general view of Peru by the time ILD was founded see the proceedings of a Symposium, edited by ILD in 1981, that took place in November 1979.
the preconditions for the most far reaching set of economic reform measures in Peru's history. Second, it would be incorrect to view the breakdown experience during the Garcia government as an aberration that then allowed the return to normally. The policies and conditions of the Garcia Presidency were another phase, albeit a drastic one, of the cycles that have characterized Peru's history." [World Bank Report n°12 096-PE p.17]

Even under these extreme circumstances, people like Vargas Llosa and De Soto, who could live well anywhere in the world, remained in Peru doing their best, at the risk of their own lives, to transform their country into a Modern Society based on the rule of Law, freedom and market economy!

Peru chaotic situation left no other way to President Fujimori: a reform program as general as possible was required. Nonetheless many reforms could be implemented and given the past experience several options were open. Faithful to his campaign promises, Fujimori conducted the reforms to create in Peru a liberal economic environment.

Trade reforms eliminated all quantitative restrictions on imports as well as import monopolies. Tariffs were set up at two levels, 15% or 25% and bureaucracy was drastically reduced. Export controls and subsidies were as well eliminated. These reforms introduced Peru once more into the international financial community as agreements with IMF and the World Bank were reached. Exchange rates were unified and free convertibility was established. Peruvians could maintain balances in any currency they wished and funds could be freely transferred.

Financial sector was also subject to a substantial reform. The banking sector, dominated by state banks of which a large fraction was bankrupt due to bad loans to state owned enterprises, was completely restructured. Regulations were concentrated on prudential aspects of banking activities; governmental commercial banks were either privatized or closed; governmental development banks were closed. Private pension funds were authorized to be created, capital market was liberalized and issuing of securities was permitted.
Interest and price controls were removed; prices of goods and services provided by the government were adjusted (they have been compressed for a long time); government employment was reduced and a fiscal reform, to simplify tax regime as well as to recompose the government ability to collect taxes, was implemented. Foreign investment controls were lifted and a vigorous privatization of government enterprises was announced. Petroperu, the state petroleum company was spared but some of her activities were sub-contracted to the private sector. Measures to reduce labor market rigidities, in special those referring to labor stability, were taken.\(^1\)

Fujimori's program raised several discontentment in an environment polluted with terrorism. Despite the initial reforms and the announcement of others to come the lack of modern institutions would produce one more coup in April 1992:

"In response to rising levels of terrorism, President Fujimori dismissed the elected assembly and the judiciary, claiming that progress could never be made against the terrorists unless he had full authority to take whatever measures were necessary. While promising an early return to democracy, the executive assumed full powers of government. The initial reaction was a large outflow of short term capital but this stopped when it became apparent that the assurances regarding a return to democratic rule were serious and that the large majority of the population supported the measure. In addition, soon after the coup, a major blow was struck against the Sendero Luminoso by the capture of most of its leaders thus engendering an increase in popular support for the government. Currently, the constitution is being rewritten by an elected assembly and a date for a referendum to ratify it is expected to be announced soon". [World Bank Report n°. 12 096-PE p.20].

\(^1\) Labor stability law was passed under a Military Government that took power in 1968. This government last until 1975 when another military coup ended a period of populism and nationalism, when foreign companies were expropriated and a radical redistributive program put in danger contracting and property rights.
Of course, Peru did not enter modernity and there is much more to be done for that. The relevance of this case for our analysis is that modernity might come from a complete failure of the old institutions in managing social conflicts. If the new constitution is written under the principles of: protecting the individual against the political power concentration in the hands of the Government; preserving the three fundamental rights and structuring the economic system on private enterprise under free market conditions, the chances of Peru to enter Modernity are very high indeed. If ILD had enough time to influence Peruvian intelligentsia, as it seems it did from the 1990 elections, a new future lies ahead. If not, Fujimori government will be one more observation, of a seesaw cycle that has prevented Peru from prosperity.

CONCLUSIONS

Latin America peoples have been trading freedom and property rights for State protection, refusing to enter Modernity characterized by freedom, uncertainties, individuality and political democratic process. Short run State protection comes through inflation and regulations that in the long run produce recurrent crises that are stronger at each cycle.

The Latin America chronically inflationary process summarizes the reaction against Modernity as well as the risks the refusal to modernize social institutions will bring to social peace and prosperity. Inflation, is currently said, is usually used as a remedy to tax system failure. In reality the inflationary process is fed by the predominance of political solutions over market solutions on economic problems.

The recurrent dominance of political solutions over market solutions is the main obstacle to Modernity. It also leads to more State intervention through state owned enterprises and regulations. This is the actual version of bribery so frequently used by Iberian Crowns and others as well, to obtain nobility support. The political power concentrated by the Government (executive, legislative and judiciary) is maintained by politicians through the "distribution" of high offices in the bureaucracy hierarchy. The bureaucracy grows fast and much sooner than later is able to feed itself by promoting

(1) Unfortunately constitutions in Latin America do not in general protect the citizen against power concentration by the government.
alliances with interest groups pleading for more regulations and discretionary power to be used on its own benefit. As usually the costs will be diffused among population in general and soon the rent seeking dispute will favor corruption.

Businessmen in Latin America are in general in favor of private property, private sector activities and competition with some qualification. Their behavior can be summarized by some on going expressions one can find in almost any country in Latin America: "Profits are private and losses are social," "Competition for my competitors and protection for my own business;" "It is the government duty to provide society with this product or this service."

Reluctance by businessmen to face the uncertainties and therefore the benefits of Modernity produces a vicious circle of economic regulations - inefficiencies - state interventions - income concentration - redistributive policies - inflation - protection and back to economic regulations.

The evil combination of continuous inflation and increasing regulations deteriorates ethical and moral values in society producing a culture of rent seeking. Under this new order there is no order despite the formal legal institutional arrangement. Informal activities become the rule not the exception. The old handicapped street vendor does not exist and you can buy almost anything in the streets. Why law obeying people buy these products without questioning their origin or the illegal nature of the transaction? Studying informal economy economists have presented long cost benefit explanations for it but we think that the rent seeking culture is responsible for the growth of informal economy in Latin America. As being daily robbed by inflation and having their three fundamental rights disrespected, the common citizen absorbs these new values produced by the rent seeking culture. In Brazil this is well known as "Gerson's Law" (to take advantage on everything). The social fabric is being teared apart.

Peru maybe reached a point were the desgobierno produced more costs than benefits to the important rent seeking groups. Reconstruction might come but the costs are very high. As we discussed above this might be the hard way to enter Modernity. Even in this case, there will be no reconstruction unless social values required by Modernity are understood by leaders in the society. How this can be accomplished?

(1) It is interesting to note that as fathers, businessmen usually impose restrictions or penalties to their children as they do bad things. Unfortunately they don't see the benefits of bankruptcies in a free market environment.

(2) Guissarri (1989) and De Soto (1986) did a systematic description and analysis of informal markets in Argentina and Peru. An occasional passant can buy used cars, refrigerators, toys, food, imported goods in any street downtown Rio de Janeiro, Brazil. In any slum (favela) in Rio you do not buy a house, since it legally does not exist, you buy the house's key. There are some middle class apartments that are bought and sold in this way but for regulation reasons.
We have no answer to this question but we can identify from historical experiences some ingredients to change mentality.

The concept of property rights is not fully understood by Latin Americans in general. Private property is legally recognized everywhere and people react as they have their land or homes invaded. Governments, though, frequently impose new regulations invalidating existing legal contracts and very few people react to them. When this is the case, as happened in Brazil when Collor Plan was implemented, the courts submit themselves to the executive interests by using legal loopholes or postponing the decision to a point in time when any outcome will make no difference.

Inflation is not seen as a government monopoly abuse and an aggression to property rights although it is frequent the identification of an inflationary tax. Even price controls are not recognized as an aggression to property rights. Equality is pursued by governments almost everywhere as an income distribution problem although the relevant dimension of this concept refers to the rule of Law that is all citizens are equally obliged to obey the Law. Privileges, subsidies and protection through regulations are frequently demonstrating that some people are "more equal" than others. By refusing to face Modernity, Latin Americans have been solving social conflicts replacing the market by the Government. This way of managing conflicts has produced more government less freedom, more positive rights that cannot be provided by the State and therefore more frustration and more conflicts. Political solutions to economic problems might be an easy way out in the very short run but, besides the efficiency cost, they are a way of aggravating social conflicts in the long run.

This consistent behavior in Latin America is responsible for a distorted view of the division of labor between the State and the private sector. State is not viewed as an institution but rather as a benevolent despot that can solve the scarcity problem to everyone at no cost. Paternalism predominates and produces as a by product a strong bias against private sector and private property. Expressions such as "social function of property" are frequently used to justify aggressions to property rights that can be as intensive as expropriation.

To revert this situation it is required the enlargement of the role of the private education system. Unfortunately education is highly regulated in Latin America and this might require a longer time until an elite is formed. In the case of Chile, the bulk
of the effort emerged in the Catholic University while in Peru, where the situation was much more adverse, the pedagogical work was undertaken by businessmen and intellectuals outside the educational system. In both cases, though, transformation came through the work of men of convictions. This was also the case of Netherlands and England as we mentioned above.

To set Latin American educational system free is not possible. The educational system has to free itself. The strategy to speed up this process is to identify the organizations in the educational system that can play a key role in the transformation and direct resources to support their activities. The business community can provide this support but first it is necessary that the educational organization discloses this reality to the community. If worse comes to worse there is always the desgobierno way.
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Autor: Carvalho, José L. (José Luiz),
Título: Private sector development and property rights in

FGV - BMHS

Nº Pat.: F162-99