

# Private sector development and property rights in Latin America\*

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Summary: 1. Introduction; 2. Property rights and social organization; 3. Property rights and economic efficiency; 4. Property rights in Latin America; 5. The ways to modernity; 6. Conclusions.

Key words: property rights; economic efficiency; Latin America; modern society; private sector.

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 was valued for his role in the society, modern society emerged from freedom valuation bringing with it prosperity that was never seen before, but also risks and uncertainties. Accordingly, 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) whose aim is to protect individual freedom and rights. The purpose of this paper is to raise some issues related to the private sector development and property rights in Latin America.

After elaborating 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, we complement our discussion on property rights by considering how this institution affects economic efficiency and consequently economic development. We raise the hypothesis that by refusing to enter modernity Latin America refuses to accept the importance of property rights. Chile is the exception to confirm the rule. 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.

A revolução introduzida pela sociedade moderna foi a de reconhecer que liberdade é altamente valorizada pelo homem e que portanto deve ser preservada e promovida. Contrariamente à organização social medieval, em que o homem valia pelo seu papel na sociedade, a sociedade moderna surge da valorização da liberdade, trazendo consigo prosperidade mas, ao mesmo tempo, riscos e incertezas nunca antes vistos. Deste modo, a sociedade moderna se organiza através de homens livres sob um "contrato social", no qual todos estão igualmente sujeitos às regras da lei. O poder político é administrado por um processo democrático e a concentração desse poder pelo Estado está sujeito a regras (Constituição) que visam a proteger a liberdade e os direitos individuais. O propósito deste trabalho é levantar algumas questões relacionadas ao desenvolvimento do setor privado e aos direitos de propriedade na América Latina.

Depois de examinarmos o conceito de direitos de propriedade e sua importância na organização social, em particular para a divisão do trabalho entre o Estado e o setor privado, completamos nossa discussão analisando os efeitos daquela instituição sobre a eficiência econômica e seus impactos no desenvolvimento econômico-social. Levantamos a hipótese de que, recusando-se a entrar na modernidade, a América Latina recusa-se a aceitar a importância dos direitos de propriedade. O Chile é a exceção que confirma a regra. Os casos do Chile e do Peru são usados para ilustrar caminhos polares que a América Latina pode usar para se modernizar. Finalizamos com algumas observações sobre o papel da *intelligentsia* local na promoção de uma nova mentalidade.

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## 1. Introduction

The great revolution of modern society has been to recognize that freedom is highly valued by man and therefore should be preserved and promoted. Contrary to the medieval society, when man was valued for his role in society, modern society emerged from freedom valuation bringing with it a never seen prosperity but also risks and uncertainties. Accordingly, a modern society is organized by free men under a "social contract" where all are equally submitted to the rules of law. Political power is managed under a democratic process and the concentration of power by the State is subject to rules (the Constitution) the aim of which is to protect individual freedom and rights.

From this same liberal root two alternatives for economic organization were developed to manage the conflict of interests among members of a society subject to scarcity: capitalism and socialism. Under capitalism, private property rights are essential to preserve freedom and to promote economic efficiency. On the other hand, socialism pleads for common property of productive resources to promote a fair distribution of output among members of a society. The recent events in the Soviet Union and in Eastern Europe are the death 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 risky 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 traits and therefore will miss important aspects of individual country cases. The historical background is based upon Latin America history books and on specific studies for some countries.<sup>1</sup>

The economic growth registered by Latin America from independence to 1950 has been attributed to her abundant natural resources. During this period the *per capita* rate of growth of Latin America kept pace with that of Europe and the United States. From 1950 to the first petroleum price shock, Latin America continued to do well, with a *per capita* income growth higher than that of the previous period. Nonetheless, relative to other regions, Latin America lost pace. The situation became worsen from the mid-70's on, with respect to the previous level of income *per capita* and, more drastically, with that of other regions.<sup>2</sup>

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

In discussing the institutional obstacles to Latin American growth, Borner, Brunetti & Weder (1992:9) 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."

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<sup>1</sup> Except when 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).

<sup>2</sup> Based on Borner, 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 authors' words, "(...) rules of the game. Institutions are sets of rules that govern the behavioral relationship among individuals or groups" (Borner, Brunetti & Weder, 1992:13). Therefore we cannot separate the values and ethics of a society from the institutions that are born under these values and ethics. Laws in their authentic meaning are social 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 becoming societies of free individuals, Latin American countries maintained after their independence the same organization implemented by the Iberian Peninsula colonizers. 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 the mid-80'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 has been 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.<sup>3</sup>

Courts are expensive and time consuming. In some countries results are unpredictable due to corruption. In others, the courts' bias, specially in favor of workers' demands, discredit justice. Seldom in Latin America the Judiciary acts as a countervailing power to the Legislative or to the Executive. Recently in Brazil, the Federal Supreme 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 section 2 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 section 3 we complement our discussion on property rights by considering how this institution affects economic efficiency and consequently economic development. In section 4 we raise the hypothesis that by refusing to enter modernity Latin America refuses to accept the importance of property rights. Chile is the exception to confirm the rule. In section 5 we use the case of Chile and Peru to illustrate different ways Latin American countries can take to modernity. We end up with a few remarks about the role of local *intelligentsia* in changing the 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 if all accept 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.<sup>4</sup> Three fundamental individual

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<sup>3</sup> See, for example, the World Bank private sector assessment for Uruguay and Peru (World Bank, 1993b and 1993c). For references on studies for Guatemala, Chile, Ecuador, Colombia and Bolivia see Borner, Brunetti & Weder (1992).

<sup>4</sup> We are not interested in identifying 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).

rights have to be preserved under the rule of law: the right to exist, the right to pursue, freely, one's own happiness, and the right to hold property.

Modern society, constituted by free individuals, is a recognition that man is free by nature and therefore the right to existence and freedom are self-explanatory. The fundamental characteristic of property rights in a free society requires some explanation. This is 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, unfairness.

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 for the physical attributes of the resource and not for its market and/or its psychological value. Thus, changes in market value of one's property, which result from other individual actions that don't alter its physical attributes, do not constitute an aggression to one's rights.

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.

Transferability is the right to exchange property rights at mutually agreeable terms. It is important that only buyer and seller approve the conditions under which the transfer of rights will take place. No third party can impose terms nor the transaction should be illegal. Thus, if price controls are imposed by third parties, included the government, property rights of those who have their prices controlled are, in a strict sense, violated.

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 the 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 the attempts of usurpation by other people.<sup>5</sup> These considerations take us to the characteristic of exclusivity of property rights.

When all costs and benefits associated to the usage of a good are appropriated solely by its owner, private and social costs and benefits are identical. Seldom the owner has control over all physical attributes of all his goods. Take as a simple example the case of getting rid of my garbage. I do have some choices. I can burn the garbage on my backyard and in this way blow smoke and ashes that will cover my neighbor's land, changing its physical attributes without his permission. I can pack it in a plastic bag and leave it in front of my house for the Municipality to collect it in the following morning. Once again, some of my neighbors will be affected by my action. The garbage smell as well as the ugly view of a garbage plastic bag on my lawn will change the physical characteristics of the environment for some of my

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<sup>5</sup> For a detailed discussion on property rights, see Barzel (1989).

neighbors. What I choose depends on its relative cost to me, irrespective of the nuisance it might be to others.

It is interesting to note how people react differently to aggressions to the characteristic of exclusivity of their property rights. Smoking in public buildings is an aggression to one's rights since the smoke will pollute the environment. Besides changing the characteristics of the environment, smoking in public places might produce negative effects on the health of non-smokers. In some countries, legal action has been taken to prohibit smoking in public buildings or even confine smokers to particular areas in those buildings. Nonetheless, in these same countries, perfume has not been banned from public buildings and, as smoking, it generates a similar impact on people's rights. The health hazard in the case of perfume might come from an allergic reaction to the aroma of some of its components.

Nowhere there are restrictions to perfume usage. Why? In part because the transaction costs to identify the allergic cases are very high. In part because most regulations result from group actions, and the lobby to ban perfume is not strong enough. Let us consider here the transaction cost aspects and postpone for the next section some considerations about regulations.

Transaction costs are important on characterizing private property rights, as well as on safeguarding them and promoting their exchange. Suppose transaction costs are bearable in such way that their existence will not prevent the market from developing. In some cases, assignment of property rights may be ambiguous, and no one is able to define properly who has what rights. Take as an illustration radio and TV frequencies.

Sound and image can be transmitted through the air at different frequencies. Broadcasting then could be developed by people establishing their radio or TV stations broadcasting at any frequency they would choose. Since the air is a common property (no excluding rights) no one can prevent anybody from broadcasting in any free frequency. As long as a rule for using frequencies is established and, consequently, frequency usage property rights are defined, there would be no conflict. Suppose the first to use a frequency has the (exclusive) right to broadcast on that frequency. Anyone interested in broadcasting on a frequency already in use by someone could only do so by buying the broadcasting rights associated to that frequency.

Unfortunately broadcasting rights were confiscated by governments everywhere. Had the government imposed the simple rule suggested above, the market would solve the frequency allocation problem, and radio and TV would not become subject to political control.

Airport noise and air pollution produced by cars are other examples of high transaction costs in defining property rights. Most unfortunately, when the governments take the responsibility to bypass these difficulties, they usually take the political route in detriment of a more efficient solution. In the case of airport noise, the simple solution would be to allow landowner compensations for noise nuisance. In general, government solutions do not contemplate noise compensations. They comprise prohibition (the Concord case), time schedule restriction (the last flight in the São Paulo-Rio de Janeiro shuttle service takes place at 10:30 PM), or the acquisition of the land around the airport to leave it without use. The nuisance compensation would produce a situation where resources would be used more efficiently.

Air pollution by cars is also subject to governmental intervention due to the high transaction costs in protecting one's rights. One cannot sue all car owners for issuing smoke due to the high cost of such a legal action. Usually pollution standards are set by the regulatory agencies, imposing a cost to consumers, with very small impact on smoke pollution and a strong distributional effect on the burden of the regulation. As reported by Kwong (1991),

the US regulation on fuel smog produced by cars misses the fact that tuned-up engine requirements would produce more impact on reducing pollution. Also the across the border standard requirement penalizes rural consumers, by increasing the price of new cars, without generating significant benefits, since these areas are not severely affected by this kind of pollution.

An alternative for car smog control is suggested by Smith (1991) and is based on the available technology that allows one to identify the degree of pollution generated by a car. Based on this fact, he suggests a pollution ranking system associated to the car licensing in such way that those that pollute more will pay a higher licensing fee. Checking points around the urban centers would prevent people from polluting more than they pay for, with the same desired efficiency as moving traffic violation is repressed.

In general, in situations such as those described above, that is, when it is difficult to characterize private property rights, government either imposes some regulations or confiscates the common property to impose restrictions on its usage. Governmental action can, though, be minimized, as also indicated above, to favor market solutions by promoting trade of rights or by imposing a cost to those that produce nuisance to third parties.

Safeguarding property rights is also subject to costs. The higher this cost, more frequently property rights will be disregarded and thievery will occur. Thus, the set of rules designed to protect private property and individual rights has to be clear and manageable at a low cost. Given the rule of law, a court system and a law enforcement system have to be maintained at a cost (resources and time) inferior to the expected losses generated by people's misconduct. If the cost of law enforcement is relatively high, breaking the law will be frequent. If the court system is relatively expensive in resources and time, breaking contracts and rules will also be frequent. Under these circumstances, the consequences for social stability, market development, and economic growth are clear. Conflicts among society members will be frequent, there will be no incentive for production, trade will be restricted to small groups, and welfare will shrink.

The exchange of property is also subject to transaction costs. When private property rights are very costly to be defined, no exchange can take place or, if it does, it will imply a high risk to participants. The difficulty in characterizing the property rights has the same effect on the corresponding traded good price as an inefficient system of safeguarding these rights. In this case, price will fall because the owner will reduce expectations about using the good, and, therefore, demand will be reduced. Also, given the low cost to steal, less people will buy the good, expecting to have access to it by stealing.

Due to Municipality regulations, several apartments in Rio de Janeiro do not legally exist. Their owners have a title on a fraction of the land where the building will be located, as well as on a specific apartment to be built. The building will legally exist if registered and certified (*habite-se*) by the Municipality. If, for any reason, an apartment cannot be certified, no one can live in it and it does not exist legally. As a matter of fact, several apartments and houses under such a constraint do exist in Rio and are traded frequently at a price below the market price.

Property rights are a dynamic concept constantly adjusted to circumstances. The velocity and the intensity of the changes in this concept depend on the benefits the new property rights will generate to society. Today, land is the only natural resource subject to a well defined system of property rights, almost everywhere in the globe. But this has not always been the case. In several societies land was a common property and for this reason was misused and a source of conflicts among society members. The change from a common property to a system of private property is difficult and some times it induces people to mix up the private property

rights system itself with the arbitrary way private property has been implemented. This is exactly the case of the Enclosure Movement in England.

As reported by Alchian & Allen (1968:474), at that time in England land was a common property and people had rights to use portions of land. Unfortunately these rights could not be traded or sold, and therefore land was not necessarily used by those who valued it most. The change to a private property system was to deny, to the tenants, the rights to use the land, and declare some politically powerful persons to be the land owners. This event produced an unjustified belief that a private property system could only be implemented by expropriating common use rights.

Another interesting historical example of property rights on land is reported by Demsetz (1967). Eleanor Leacock and Frank G. Speck, in two anthropological studies about indians of the Labrador Peninsula, had discovered that they had established family property rights on land. Since these were communities that lived on fur trade, they depended on the conservation of the animals from which they extracted the furs. The private property system on land prevented extensive hunting since it was in the landowner's interest to conserve the animal population on his land to guarantee a permanent flow of furs. This is an interesting example of the superiority of the private property system over the common property one, and it illustrates the universality characteristic suggested by Posner.

The above discussion stresses the importance of transaction costs in characterizing property rights, as well as the implications of these costs for the efficient use of resources. If transaction costs did not exist in a free market society:

- a) there would be no *externalities*, that is, one's action would not produce uncompensated costs or benefits to third parties; since it would be costless to identify these costs and benefits, the characterization of property rights would define the direction of these compensations;
- b) property (resources) would be used on their highest valuation in society, since private and social costs would be equal (no externalities);
- c) the use of private property (resources) would be independent of the original distribution of rights, as long as they could be freely traded.

These arguments were developed originally by Coase (1959, 1960) and are well-known as the *Coase Theorem*, providing us with the foundations to suggest a division of tasks between the private sector and the State.

Societies are organized under a State for the same basic reason businesses 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 it is the function of the State to provide conditions for a harmonic life under the rule of law and for the development of economic activities under a 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 exacerbate conflicts over the use of resources, reducing the economic efficiency of the market or making its development impossible in some cases.

Property can be private, public 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 co-operatives. Public 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 for reduced risks in relation 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’s proposition. Social mores and common law provide society with the necessary order to make the 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 with 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 come 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, 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.<sup>6</sup> Private property rights are 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 from 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 sometimes considered as market failures. We prefer to consider them as imperfections in the information market, and, therefore, they will not be considered in this discussion.<sup>7</sup>

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*) prevents the develop-

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<sup>6</sup> For a summary and a critique to Lange’s argument, see Nutter (1968).

<sup>7</sup> For a discussion of these cases as imperfections in the information market, see Kreps (1990).



ment 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 taking advantage from this monopoly, 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 eliminates the indivisibility, and, therefore, there is no argument left to justify the natural monopoly solution. This is the case of telecommunications through satellite. The possibility of renting the satellite services for communications eliminates the cable infra-structure investment indivisibility in interurban or international telephone services. This happens in the US, but public authorities in Latin America insist on maintaining State monopoly of this service. Even urban telephone services might lose their monopolistic condition with the advent of mobile 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 allow 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 reduction of any other consumer's possibilities of having the good. But someone has to pay for the good to be produced. Therefore, a financing problem is implicit here. 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 society much higher than the cost of having taxes to finance its production. Note that taxes are confiscation of income produced by private owned resources. Also, public authority action with respect to public goods can be restricted to the promotion of incentives to finance production. In this way, the government does not need to produce the public good for society to enjoy it.

In general, in a society of free individuals, scientific knowledge is produced by the private sector. The government might allocate funds to promote scientific 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 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 completely 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 through the protection of the inventor's property rights 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 absence of private property or an improper definition of property rights. In the first case, who should be excluded from enjoying the common property? In the 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 high.

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 permanent by restricting fishery activity through licensing and establishment of fishing seasons.

When transaction costs are high, governmental regulations are frequently used to prevent misuse of the common property. The problem with governmental regulations is that they turn an economic problem into a political one. In this respect society always loses, 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 interest groups. Since there is no formal market for regulations, restrictions on lobby activities have to be imposed to prevent groups from producing legal constraints on others for their own benefit. Regulations are a transitory solution because technological progress might reduce transaction costs in such a way to make it possible to legally impose 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 circumstances. Note that prior to the invention of barbed wire the cost of identifying one's private property in the American West was very high and therefore common pastures were usual, although inefficient (Anderson & Leal, 1991).

Regulations are followed by the creation of a bureaucratic body highly interested in preserving its political power. Most frequently, discretionary powers are conceded to those 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.<sup>8</sup>

Once economic regulations get started, bureaucracy will actively promote more regulations on its own interest. Interest groups will join bureaucrats in this regulatory effort in order to drive regulations to promote their welfare.<sup>9</sup> 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 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 these are no chimeras.

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<sup>8</sup> See, for example, De Soto (1986) and Burger (1991).

<sup>9</sup> On the economic regulation, see, for example, Stigler (1971) and Peltzman (1992).

Thus, the administration of common properties as well as 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 a way to prevent bureaucrats from having any kind of discretionary power.

It is clear that the absence of private property will prevent people from enjoying the benefits of 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 society's interest develop technology to characterize property rights, and thus prevent significant market failures.<sup>10</sup> It is also in society's interest to define an efficient system of property rights (in Posner's 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 is private and free markets are well-developed will experience higher levels of prosperity as compared to others where private property does not exist or is subject to institutional instabilities. It is exactly in the context of economic growth that the permanent characteristic of property rights can be most appreciated.

Economic growth derives from increasing production possibilities. It is promoted by new knowledge applied to production (new technology) and by the increase and improvement of the quality of production factors (labor and capital). If private property rights are not permanent, there will be no incentives to private investments or savings. Without private investments and savings, economic growth can be conditioned to government action only. Since government actions are taken by political reasons, and not by market prices, society will experience smaller growth, if any.

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 organized politically as a democracy and (except for Cuba) economically as a capitalistic system. Far from this view, Latin America lacks the main ingredients for democracy and capitalism, a system that defines and enforces properly the individual fundamental rights.

To understand Latin America's current situation it is instructive to review briefly how its societies were formed and how their Iberian inheritance played a decisive role in produc-

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<sup>10</sup> 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 increase its value and promote free market.

ing the Latin American culture. Discovered and colonized by Spain and Portugal (Iberian Peninsula countries), that for quite some time, during the colonization period, were unified, under a sole crown, all countries in Latin America inherited the Iberian culture.

By the time of the great discoveries and along the colonization period (16th through 18th 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 from the 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 & Thomas (1973:130) 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."

As tax revenue increased, expenditures increased faster but the Spanish Crown did not cut expenditures given its goal to expand the empire. Borrowing was the way out once taxing limit was reached. North & Thomas (1973:129) report 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 its main goal, and non-orthodox procedures were put into 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, 1973:131).

North & Thomas (1973) contrast the stagnation of France and the decline of Spain with the prosperity of the 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 the two first countries failed to establish and enforce the rule of law to preserve the fundamental individual rights. In particular, they acted 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 intellectual production in England. But these outcomes do not result from pure chance. French and Spanish Crowns maintained 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 requirement of a private property system to make it work. The ascendancy of the Parliament over the Crown kept England from engaging in a expansionist policy such as that 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 the mother country. Latin America independence from Iberian Crowns started around 1820. All new countries — except Brazil and Mexico, the latter for a short period — adopted the modern State paradigm crystallized by the 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 it refuses to engage in the modern society road of uncertainty and risks, as well as of freedom and property.

The political-economic system of the new countries was the same of the colonies. Local government replaced the Crown. The system of *encomiendas* or *repartimentos* was replaced by the *latifundia* or great estate. The main economic activity continued 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 results of its 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 in building a nation. Their standard of living and values were European, and the low tariffs imposed on imports allowed them to enjoy the same products and novelties the Europeans and North Americans did. 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.<sup>11</sup>

One might argue that the evidences are contrary to this explanation, since the Constitutions of these new countries reflected the concept of a modern State. Property rights were explicitly defined, as well as the main role of the State of providing and enforcing the rule of law. It is our view that it is a mistake to read Latin American Constitutions as such. As Guissarri (1989), in a different context, puts it, the Constitution was viewed as an agreement that allowed groups to participate in a good business.<sup>12</sup> This concept certainly is not restricted to Argentina. Since its independence, Latin America promulgated 255 new Constitutions until the early 1980's. This corresponds to an average of 10 Constitutions per country that lasted on average 16 years each (Rosenn, 1984:8).<sup>13</sup> Recently, a group of businessmen in São Paulo formally suggested that in reviewing the current 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 approve regulations on their benefit. If these regulations are in the Constitution, the expected gains will be higher because the loss of the corresponding benefits will be much more difficult to occur since it will require another change in the Constitution.

Except for Chile, all other countries organized as a Republic had their first government headed by the military. After a period of State organization and some armed conflicts, domestic and among neighboring countries, the military became an organization in quest for a role. Thus they proclaimed themselves and made it clear in the Constitutions that they were the guardians of the Constitution. This might explain why military coups as well as changing Constitutions are so frequent in Latin America.

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<sup>11</sup> See, for example, Anderson (1967).

<sup>12</sup> Guissarri discusses here the relationship between Constitution and informal activities in Argentina. His analysis starts from the "constitutional agreement of 1853".

<sup>13</sup> It is important to note that at each new constitutional revision more and more positive rights are granted to groups and the role of the State in society is consistently enlarged.

By the early 1900's the colonial exporting model began to show its weakness. Refusing to enter modernity, Latin American elites pressed governments to provide the means for increasing or preventing their rents from dropping. Investments in infra-structure were required but the state could not collect enough taxes to realize the required investments. Also, human capital expertise lacked and Latin America competed with other regions to attract foreign capital. To promote direct foreign investment local governments offered grants in land, liberal leases to subsoil rights, guaranteed rate of return on investments, and cheap credit, among other benefits. Later on, along late 50's through the early 70's, foreign capital would be discriminated and in some cases would have its businesses expropriated by the State. After the 1982 international financial crisis, borrowing abroad was not possible to Latin America, and given its large foreign debt, direct foreign investment was once more favored by several countries.

These events demonstrate how politically and economically unstable has Latin America been. In some senses, this instability results from the refusal to enter the Modern Era. Latin America gravitates around modernity, absorbing the main issues from the modern and developed world, but refuses to take the risks of modernity in order to collect its benefits. Latin America, as many other areas in the world, is structured as a medieval society disguised as modern by its modern institutions (property rights, individual rights, markets, democratic political process), organizations (business firms, capitalism, government), and consumption goods (automobiles, mobile telephone, TV, PCs). The refusal to modernize and the mimetic behavior of its elite can be identified in the following examples.

The anarco-syndicalism of the early 20's in the developed world, in special in Europe, was absorbed by Latin American *intelligentsia*. The inequalities produced by the Industrial Revolution gave birth to the Marxist-Leninist "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 political or economic, were almost completely disregarded by Latin American elites.

The 1930 world recession produced in Latin America more economic growth than recession but not without a cost. World trade was reduced and 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's political-economic arrangement. Rents were redistributed from exporting sectors to the import substitution industries. Most of these new opportunities were explored by the elites, who directed their economic resources, as well as their political power, to explore these new opportunities. To preserve the economic rent of these elites, 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 for by "isolating" Latin America from the world crisis was an increasing participation of the State in economic activities and more protection, now expanded to the newborn 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 be-

came explicit to all through the implementation of a government managed social security system. Apparently property right aggression, through price controls, taxation, increasing inflation, and protection, was not identified by the elite, who benefited in the short run from the State action, nor by the people, ignorant and happy with the State protection.

This process in general would continue in a slow pace, with a different dynamics according to each country's conditions, until the end of World War II. As domestic interest groups diversified their demands on the State, the government enlarged its role in society, promoting reforms in favor of the new political groups but preserving the previous exporting commodity model. Inflation was used by the government to satisfy the increasing demand for protection. State enterprises became a natural way to provide the private sector with cheap inputs, and regulations continuously produced benefits for small groups, promoting corruption and a steady growth of bureaucracy. Industrialization through import substitution was deliberately promoted by the government, increasing inflation, regulations bureaucracy, and corruption.

Latin America's private sector was developed from this incestuous relationship between social groups and the government. As the purveyor, the State took the form of a paternalist government that protects the private sector from domestic and international competition.

Protection distorted market prices and the private sector demanded governmental action to eliminate those distortions. To compensate those activities negatively affected by protection, the government imposed price controls, regulations, surtaxes, in a constant and frequent disrespect to property rights. New distortions required more protection, that produced more governmental intervention, that produced more distortions, and so on. Since the government responded to private sector demands, the private sector did not realize how this vicious circle of increasing economic regulation and economic inefficiency endangered social stability, private property and private sector activities.

Inflation was an immediate consequence of the purveyor role played by the State in Latin America. The forced savings argument was spread all over the continent to justify the inflationary wave that invaded all countries. Underdeveloped (this was the word used for Third World at that time) countries have a low savings capacity. Therefore, an inflationary tax, identified as forced savings, would be the instrument for the government to finance investments in infra-structure. This other source of government growth exacerbated the dynamics of the economic regulation/economic inefficiency vicious circle.

More recently after the fall of Berlin Wall and the dismantling of the Soviet Union, a "new fashion" struck Latin American governments. The success of the new-liberalism in Ms. Thatcher's England and Mr. Reagan's US brought about a wave of deregulation and privatization that reached the majority of Latin American 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 the early 80's.

Boecker (1993) edited a book on the privatization experience of several Latin American countries. He is quite optimistic with respect to this process: "there is little doubt that Latin American governments are genuinely committed to privatization" (Boecker, 1993:13). Nevertheless, he recognizes the difficulties imposed by a poor capital market, prejudices against foreign investments, excess regulations that endangers market functioning, and, especially, the inflationary environment.

From the studies reported by Boecker it is clear that privatization in Latin America is a matter of government budget constraint given its macroeconomic stabilization objectives. It

seems that only in Mexico the emphasis moved from the cash flow aspect to private sector demand. Nonetheless, the Mexican private sector demands privatization only for “nonstrategic industries”, that is, privatization is welcome as long as it does not eliminate the important protection content of government entrepreneurial action.

In the Brazilian case, after the impeachment of ex-president Collor, the program has been revised and no substantial progress has been made. The Labor Party proposal for the 1994 presidential campaign on this issue was radical: suspend the program and review all cases of privatization to identify those enterprises that should be brought back under government administration.

Through this reading Latin America history — 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. Government protection has been the goal of the large majority of the private sector. The development of a close relationship with high officials is the current version of being the king’s friend. Since this is the rule of the game, the private sector very quickly absorbed the information to survive and prosper. Resources were directed to promote regulations and protection, bureaucracy and corruption, as well as to increase the role of the State. For those who had no access to privileges, life was very difficult, and a large fraction of these “unfortunate” were 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 government intervention.<sup>14</sup> It is in fact an attempt to survive and prosper but at a very high cost to 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 Peruvian 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. This might become unbearable. In this way, the informal sector works as an “invisible hand” plowing future disorder and social chaos.

In our understanding, informal activity is a legal activity developed not under the law but at the margin of the law. The activity itself is not illegal, but it is performed without considering all legal constraints. Thus, smuggling foreign goods through the border is an illegal activity as well as robbery and murder. It is also illegal not to pay due taxes. Nonetheless, a legal activity, say the sale of candy, performed without the corresponding tax payment is considered an informal activity. In a strict sense, all informal activities are lawless but are not illegal.

Since informal activities are lawless, property rights in an informal transaction environment cannot be fully protected. Therefore, all the gains from a well-defined property rights system are lost as informal markets develop. But why informal markets developed all over Latin America? As we understand this phenomenon, it is a result of the failure of the government due to the abuse of its coercive power (Executive and Legislative), to its omission on providing a stable institutional environment (Constitution), and to its inefficiency in managing the judicial system (Judiciary). Of course, governments reflect social values and social

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<sup>14</sup> In countries such as Brazil and Argentina in the 80’s the informal sector corresponds respectively to about 50% and 60% of the measured GDP, according to Lima (1985) and Guissarri (1989).



demands and, therefore, government action is conditioned to the prevailing mentality in society. We will return to this aspect in the last section of this article. Let us elaborate here on government failure.

The abuse of coercive power by the government produces excess taxation and regulations, as well as inflation. These are, in fact, instruments used by the government to manage the conflicting demands imposed by the rent seeking groups that emerged in Latin America. Excess of government intervention increases instability, which will induce the private sector to press the government for more intervention. By increasing and constantly changing taxes and regulations, the government raises transaction costs in such way that, for some private economic agents, to trade informally generates, in the short run, gains not attainable under formal arrangements.

As inflation increases, the inflationary tax becomes more evident to everyone. Common people become more flexible about their moral values, once they perceive they are being robbed by inflation every day. Informal alternatives become largely accepted not only by businessmen but mainly by consumers. Buying at a lower price, no matter what, produces a wide connivance with informal markets, that eventually, as in the case of Brazil, will incorporate smuggled and stolen goods.

Informality spreads over all activities in society, including housing and transportation, as in the case of Peru.<sup>15</sup> Public authorities, eventually, accept informal markets and, as in the case of transportation in Peru, act in agreement with their interest, imposing off-the-record regulations and price fixing rules. Connivance with informal markets promotes corruption and connivance with the latter. Social values and institutions are weakened.

In Latin America, courts are expensive and slow in providing justice. Legal disputes, under the above circumstances, increase at a very high rate, and legal processes pile up in front of judges, extending the time one has to wait for settling a legal dispute. New courts are opened at the expense of judicial quality. Less reliable becomes the system and more disrupted become the institutions.

Government budget deficit and a growing inflation give birth to stabilization policies based on confiscation, compulsory loans to the government that are never paid back, unpaid public debt, State intervention on legal private contracts, price controls, unconstitutional taxes, more taxes, and, of course, more government expenditures. The heterodox plans implemented by Brazil and Argentina in the second half of 80's are good examples of such stabilization policies. People lost confidence on and respect for the government, as the 1989 Bolivian effort to promote private investments dramatically illustrates it (Borner; Brunetti & Weder, 1992). No wonder private investments have been drastically reduced in Latin America, with a direct implication for economic growth.

Looking at the Constitution, codes and laws of a typical Latin American country, one will understand why situations like those are so common. Concentration of power in the Executive, lack of checks and balances among government branches, and a misconception of the role of the Constitution are the common ingredients that have been producing such institutional instability in Latin America.<sup>16</sup>

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<sup>15</sup> See, for example, World Bank (June, 1993).

<sup>16</sup> These elements have also been identified by the World Bank private sector assessment on Uruguay as well as Borner, Brunetti & Weder (1992).

## 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. This is also true for ways of Latin America to enter modernity. But we will consider two completely different ways based on the experience of two possibly extreme cases: Chile and Peru. Heirs of the same Iberian culture, they had been treated differently by their mother country. Lima was chosen as the metropolis of the Hispanic America, while Chile remained as a simple province. The difference goes further back, prior to the arrival of the *conquistadores*. Peru was the Inca country, the most advanced civilization in all Americas. Unfortunately the Inca’s organization and progress were responsible for their almost total destruction. Peru’s independence came about easily, because Spain was fighting against the independence of Chile, Colombia and Argentina. Nonetheless, after its independence, Peru lost its smooth paths.

Ironically, Peru and Chile fought a war in 1879 over some territories rich in nitrate deposits. Peru lost the war and the territories.<sup>17</sup> Since 1875, the Chilean economy, based on wheat exports, was suffering from the surge of new plantation areas in North and South America, Russia and Australia. These new competitors, much more productive as compared to Chile, drove the country 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 its independence in 1821, and during the four years of war, the country had seven presidents. The Chilean military winners gained prestige and respect but did not take over local government, while the Peruvians losers 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 have chosen particular roads that, in many aspects, are the same as those selected by any other Latin American country. Here we will stress the particularities that made Chile and Peru two polar examples in Latin America.

### Chile

The year of 1883 not only marks 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.

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 only be reduced 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, especially those referring

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<sup>17</sup> The Pacific War lasted until 1883, and Peru joined Bolivia against Chile over the territory dispute.

to education and social welfare. Largely composed by professionals (lawyers, professors, physicians etc.), the middle class strongly contributed to create in Chile a general recognition of the importance of personal liberties. If valuation of personal liberties favored the private sector and property rights, it also favored the development of communist party action. Since liberties and not freedom were the main value, Chile became subject to some radical group actions.

By early 20's, Chile had a large proletariat, for Latin American standards, favored in its political action by the urbanization and the consequent rupture of the family as a political unit. Only Uruguay could be compared to Chile in this respect at that moment. The permissiveness of the personal liberties concept and the fast urbanization imposed some costs on Chile. Electoral liberty meant "liberty to indulge in fraud and bribery" (Johnson, 1958:76). 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 unsanitary quarters. Infant mortality rate became the highest in 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. Labor leaders in Chile were strongly influenced by European leaders with whom they were in constant touch. Labor movements developed independently from the State, contrary to what would happen later in Argentina, Brazil and Mexico. Also, labor movements did not restrict their action to labor demands. They played an important political role and favored the growth of the personal liberties value. Their action was 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 white-collar employees of Chilean nationality. This percentage was raised to 85% in the 30's.

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

The importance of the middle class and the cultivation of individual liberties as a value are, as we understand, the particular elements that made modernity possible in Chile. Nonetheless, the passport to modernity would only be issued 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-rightists. During the Cold War, Chile received economic and technical support from the US, as did several other countries in Latin America. Despite the approval, in 1948, of the Defense of Democracy Law, that made the Communist Party illegal, xenophobia and socialism were growing in Chile. The socialist bias reached a peak during the Allende government. Elected with 37% of the votes and presenting a program to implement socialism in Chile, Allende's government expropriated large firms, farms and private banks. A large program of wealth distribution accelerated inflation and government deficit. This program produced industrial stagnation, smaller farm output and a military coup in September 1973.

Socialism was growing in Chile during the 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, which resulted from

several years of consistent investment in human capital, concentrated at the Catholic University at Santiago, saw these items as a threat to freedom, private property and market economy, as well as to democracy. As reported by Harberger (1993), this group was politically very active and engaged in the 1970 electoral dispute supporting Jorge Alessandri.

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). Harberger 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, 1993:345).

As in the case of the Netherlands and England, men of convictions played the important role in transforming Chile. The existence of a middle class that valued individual liberties, established at beginning of this century, was the amalgam that made possible the development of the Catholic University group. Its convictions were so well nourished and developed that despite the political system being organized under a military dictatorship, it 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 its independence in 1821 until the 1990 elections, Peru had 80 presidents, 53 of which were members of the military.<sup>18</sup> This dramatic record summarizes the permanent political turmoil in Peru which prevented the establishment of modern institutions to manage social conflicts.

Successive short governments contributed for an endemic budget deficit with the tax burden concentrated on imports and exports. Government 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.<sup>19</sup> The economic conditions strongly affected political stability. Stable governments are associated to favorable world price conditions for Peruvian exports (e.g., 1895-1919, the Korean War period).

Government failure in providing public goods and services, in special a legal system (the rule of law), is the main factor responsible for the high frequency of military coups Peru has been subject to. When economic conditions deteriorate and social conflicts grow, the way out in Peru has been a coup. The new government tries the same remedies but in different doses with about the same results. The ingredients have been nationalism and populism.

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<sup>18</sup> This record implies an average of two years and 45 days for each president and that two out of three presidents were members of the military. For a brief summary of Peruvian history, see World Bank, 1993c.

<sup>19</sup> Favorable exporting prices increased tax revenues and also permitted servicing foreign debt, therefore maintaining Peru in the international financial market.

Very rarely occurred a few attempts to promote market economy, but even then the low level of the people's education and the strong limitations imposed by a precarious judicial system aborted the attempt or concentrated opportunities to a few. This contributed to a strong socialist bias in Peruvian society that would only be partially neutralized by the determined action of a group concentrated at the Instituto Libertad y Democracia. Founded in May 1980 under liberal principles, the 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 without privileges.<sup>20</sup> Identifying the lack of property titles, and, therefore, the enforcement of property rights as a major requirement 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 the Peruvian government. The main reason for having a private institute registering property is the total failure of the government in providing this service, as well as the lack of confidence people place on public institutions in Peru.

The ILD has been producing research and other public services. Playing a decisive educational role in the Peruvian society, the 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 former Soviet Union contributed for 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 the ILD staff, most of the time under life endangering situations, paved the way for this outcome. Only men of convictions could continuously work under the circumstances faced by ILD in the 80's.

First, constantly threatened by the actions of the terrorist group Sendero Luminoso — whose principal goal was to destroy current Peruvian society to build a new one based on Maoism —, due to its action in favor of the rule of law as well as to its activities of registering rural properties in special, the ILD raised against it and its staff the anger of terrorists and narcotraffic groups.

Besides, the country's 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 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 García government as an aberration that then allowed the return to normality. The policies and conditions of the García presidency were another phase, albeit a drastic one, of the cycles that have characterized Peru's history" (World Bank, 1993c).

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

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<sup>20</sup> For a general view on Peru by the time the ILD was founded, see the proceedings of a symposium that took place in November 1979 (ILD, 1981).

own lives, to transform their country into a modern society based on the rule of law, freedom and market economy!

Peru's 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 choices could be made. 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 at two levels, 15 or 25%, and bureaucracy was drastically reduced. Export controls and subsidies were eliminated as well. These reforms introduced Peru once more into the international financial community as agreements with the 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.

The financial sector was also subject to a substantial reform. The banking sector, dominated by State banks, a large fraction of which was bankrupt due to bad loans to State owned enterprises, was completely restructured. Regulations were concentrated on prudential aspects of banking activities; government commercial banks were either privatized or closed; government development banks were closed. The creation of private pension funds was authorized, capital market was liberalized, and security issuing 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 owned petroleum company, was spared, but some of its activities were subcontracted to the private sector. Measures to reduce labor market rigidities, in special those referring to labor stability, were taken.<sup>21</sup>

Fujimori's program raised discontent 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, 1993c).

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

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<sup>21</sup> The labor stability law was passed under a military government that took power in 1968. This government lasted until 1975, when another military coup ended a period of populism and nationalism, in which foreign companies were expropriated and a radical redistributive program put in danger contracting and property rights.

of the old institutions in managing social conflicts. If the new Constitution is written under the principles of protecting the individual against the concentration of political power 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 entering modernity are very high indeed. If the 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's government will be one more observation of a seesaw cycle that has prevented Peru from prospering.

## 6. Conclusions

Latin American 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.

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 current 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.<sup>22</sup> Bureaucracy grows fast and much sooner than later it is able to feed itself by promoting alliances with interest groups pleading for more regulations and discretionary power to be used on their own benefit. As usual, 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 current expressions found 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's duty to provide society with this product or this service".<sup>23</sup> 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 more regulations deteriorates ethical and moral values in society, producing a rent-seeking culture. Under this new order, there is

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<sup>22</sup> Unfortunately Constitutions in Latin America do not in general protect the citizen against power concentration by the government.

<sup>23</sup> It is interesting to note that as parents, businessmen usually impose restrictions or penalties to their children when they misbehave. Unfortunately they don't see the benefits of bankruptcies in a free market environment.

no order despite the formal legal institutional arrangement. Informal activities become the rule, not the exception. The old handicapped street vender does not exist and you can buy almost anything in the streets. Why law abiding people buy these products without questioning their origin or the illegal nature of the transaction? Economists have presented long cost/benefit explanations for informal economy, but we think that the rent-seeking culture is responsible for the growth of informal economy in Latin America.<sup>24</sup> Being daily robbed by inflation and having his 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 torn apart.

Maybe Peru reached a point in which the *desgobierno* produced more costs than benefits to the important rent-seeking groups. Reconstruction might come but the costs are very high: 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? We have no answer to this question but we can identify, from historical experiences, some ingredients to change the mentality.

The concept of property rights is not fully understood by Latin Americans in general. Private property is legally recognized everywhere, and people react when 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 it 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 the identification of an inflationary tax is frequent. Even price controls are not recognized as an aggression to property rights. Equality is faced 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 the 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.

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<sup>24</sup> Guissarri (1989) and De Soto (1986) made a systematic description and analysis of informal markets in Argentina and Peru. An occasional by-passer can buy used cars, refrigerators, toys, food, imported goods in any street down-town 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 also some middle class apartments that are bought and sold in this way, but for regulation reasons, as we explained before.



To revert this situation it is required to expand 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.

It is impossible to free the Latin American educational system from the outside. 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 for the educational organization to disclose this reality to the community. If the worst comes to the worst, there is always the *desgobierno* way.

We understand that to change mentality will take one or two generations and Latin America cannot wait that long. Provided the effort to free the educational system is undertaken, it is clear that some men of convictions would be engaged in the transformation project. A parallel effort to reduce the size of the government should be undertaken. In the three World Bank private sector assessment reports mentioned in this paper, businessmen identify excess taxation as one important impediment to private sector development. They did not identify, in all cases, regulations as much important because the benefits they get from them are very clear, while the costs are difficult for them to identify. In any case, reducing the size of the government implies reducing regulations.

A general principle for reducing the size of the government can be expressed in terms of efficient use of resources. Consider *to do something better* as to produce the largest net benefits to the society. Thus, the Union should not do what the states can do better; the states should not do what municipalities can do better, and the municipalities should not do what individuals by themselves or in groups can do better. This principle would substantially reduce government activities in Latin America. In this way, for example, retirement plans could be managed by the private sector, with some room for humanitarian action by the government (as in Chile), and SOE could all be privatized.

Constitution, codes and laws should be revised, and the rule of law condition should be restored. Constitution is to protect individuals against political power concentration by government. Codes and laws should be simple and clearly conceived to reduce transactions costs by properly defining property rights and to protect third parties interest.

To restore judiciary credibility, the court system should be reformed to promote decentralization and modernization, as well as private arbitration to reduce the time lag in legal disputes. This would eliminate legal instruments created to protect rights considered to be threatened without any consideration of the plea merits. In the Brazilian case there has been an abuse on the use of these instruments and it is public knowledge that "liminares" are a source of corruption. Also, judges should be held responsible for their technical mistakes as well as better prepared to perform their duties in a modern society environment. If there is a branch of the government that cannot fail in performing its task, this branch is the judiciary. The rule of law condition is the institution that preserves the social order required for economic growth and self-sustained prosperity of free individuals societies.

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