
REFORMING THE PUBLIC SECTOR IN LATIN AMERICA: A CROSS-COUNTRY PERSPECTIVE

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Abstract

After decades of poor economic management in Latin American and Caribbean countries, structural reform has placed the region on a path of improved economic performance. Two basic principles can be considered responsible for this process of economic reform: fiscal and monetary discipline, and reliance on market forces to determine the allocation and distribution of resources. In most developing countries, greater reliance on market forces has meant a complete revision of the role of the state, transforming the public administration from a bureaucratic administration into a managerial one. This paper examines the main issues which have led to the reform of the public sector in five Latin American countries: Argentina, Brazil, Chile, Colombia and Mexico. Their experience provides important lessons to be taken into account and a rich set of cross-country comparisons.

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1. Introduction

At the end of this century the role of the state in the economy has been the object of heated debate. In Latin America, specifically, after decades of poor macroeconomic management, greater fiscal discipline and the structural reforms of the late 1980s and early 1990s have led to improved economic perfor-

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mance with reduced participation of the state in the economy [Edwards (1995) and Loayza and Palacios (1997)]. In most of the region, these policies have helped to spur economic growth, reduce economic volatility, and halt the trends toward worsening income distribution and increasing poverty. In many of instances, the effects have been substantial, but are still insufficient for attaining the growth, stability, and social equity desired by society.¹

Three broad factors created the conditions for a diminished role of the state in the economy: (i) a need to reduce public spending; (ii) a soaring enthusiasm for market solutions among Latin American elites; and (iii) a growing disenchantment with the effectiveness of state intervention. These three factors nurtured an environment in which any initiative aimed at strengthening the public sector had to overcome enormous obstacles [World Bank (1997a)].

However, sustaining and deepening the positive changes brought about by the turn to the market will require states to increase their technical and managerial capacities far beyond present levels [Bresser Pereira (1997)]. Moreover, unless the administrative capacity of Latin American governments is increased, social conditions are bound to deteriorate, regardless of how much money is poured into social programs. Although it is necessary to reduce further state intervention in the economy, there should also be an effort to create conditions for the state to play its traditional roles efficiently, as well as meeting the demands created by the market-oriented policies adopted in the last decade.

This paper discusses the process of public sector reform in five Latin American countries: Argentina, Brazil, Chile, Colombia, and Mexico. Their experiences provide a rich set of cross-country comparisons and important lessons for Latin American and other developing countries. The paper has four sections. Following this introduction, Section 2 discusses the timing and scope of public sector reforms in Latin America. Section 3 focuses on cross-country experience, examining issues such as decentralization of public services, privatization, financial reform and administrative reform. Emphasis is given to the issues of privatization and administrative reform due to their relative importance in the present regional context. Section 4 discusses some pending issues and offers some concluding remarks.

1 According to the IDB (1997), the failure to push further with market-oriented reforms can be blamed, at least in part, for this outcome. In fact, in most countries of the region, even those where market-oriented reforms have advanced the most, the state continues to perform functions better suited to the private sector while exhibiting an appalling incompetence in discharging core public functions. See also the IDB (1998) for the problem of unequal income distribution in Latin America.

2. Timing and Scope of Reforms

Following the economic crisis of the 1980s, the highly indebted countries in Latin America carried out fiscal adjustment, trade liberalization, privatization and deregulation. Efforts to rebalance government spending and borrowing had positive outcomes: relative control was regained over balances of payments, inflation rates fell everywhere, and countries recovered some of their creditworthiness. As a result of these positive developments, the region has recently attracted more than US\$ 50 billion per year, eight times more than in the 1980s and twice what it used to attract before the 1982 crisis.

The process of change, however, was not as straightforward and swift as this description might suggest. Nor was the “ideal” sequencing of the reforms – economic-stabilization followed by structural changes – implemented [Naím (1995)]. In most Latin American countries, the adoption of structural reforms was preceded by deteriorating economic conditions that included declining investment rates, low or falling growth rates, large fiscal deficits, accelerating inflation, and a sharp contraction of financial intermediation. Why did countries wait so long finally to launch these reforms? Why after so many years of economic deterioration were the reforms eventually adopted? Why is the adoption of these reforms so often a protracted process? Two basic sets of answers have been given to these questions.

First, there are arguments based on the role of distributive struggles among interest groups. According to this view, economic deterioration comes about through the endogenous evolution of an economic variable (public or external debt, degree of financial adaptation, information about another group’s preferences) that determines the cost to each group of further delaying reform. When the situation deteriorates to the extent that the present value of a no-reform scenario falls below that of a reform policy, groups agree and changes in economic policy are implemented [Alesina and Drazen (1991), Labán and Sturzenegger (1994), Velasco (1995) and Tornell (1995)].

Second, there is an alternative view according to which periods of economic disarray convey information about the mapping between outcomes and policies and may lead to a reassessment of the cost of previous policies. In this alternative view, reforming economies first observe external changes – e.g. growing trade, new technology – and the older model of development gradually appears to be less adequate. As the world evolves, perceptions change, but only slightly, since people only observe economic outcomes, and cannot readily ascertain whether poor outcomes result from inappropriate policies or simply from adverse random shocks. As learning occurs slowly over time, inap-

appropriate policies can rationally remain in place for long periods, causing a gradual but painful deterioration of economic performance. Only when enough learning has occurred is reform successfully carried out [Harberger (1993)].

However, no matter what may be the arguments of political economy on the tardiness of reforms, partial reforms remain inherently unstable if complementary reforms are not implemented. For example, fiscal consolidation – rationalizing and cutting public spending or raising tax revenues – will be more acceptable if the society faces a risk of losing recently attained price stability. Trade liberalization, on the other hand, exposes local producers to foreign competition and increases the benefits of the reforms; this, in turn, improves the efficiency of the tax system and the operation of factor markets, reducing the cost of non-tradable intermediate inputs such as public services [Gavin (1997)].

A crisis typically makes the pre-reform phase so costly that the various conflicting groups in society quickly reach an agreement on the reforms needed. Although economic crises may set off the reform process, it would be rash to say that crises are its cause. Domestically, political and ideological factors influence the timing, intensity and direction of reforms. External factors also play a decisive role in encouraging countries to unite on the reform process. The growing importance of trade blocs, globalization, and the need to improve international competitiveness has also compelled countries to implement structural reforms [Fernandez-Arias and Montiel (1997)]. During the 1990s, almost all countries have taken up the task of opening up their economies and liberalizing and strengthening their financial sectors. Notable advances have also been made in privatization, although with major differences from one country to another. Typically, stabilization and privatization have tended to be implemented rapidly, while financial, labor market and social security reforms have been implemented only gradually. Trade liberalization and tax reform are intermediate cases, in which neither gradual approaches nor shock treatments have been the rule [Edwards (1995)].

In what follows we review the main issues involved in the reforms adopted in five Latin American countries during the 1990s. We analyze the cases of Argentina, Brazil, Chile, Colombia and Mexico since they are leading the region towards a more market-oriented economic structure. The lessons learned from them can help guide the countries in the region that are lagging behind in the process of public sector reform.

3. A Cross-country Perspective

3.1. An Overview of Initial Conditions

In Table 1 one can clearly see that most of the countries under review underwent some sort of fiscal adjustment in the early 1990s, with the exception of Chile, which has accumulated surpluses since the 1980s.

In Argentina, the provinces have traditionally accounted for a large part of the overall fiscal deficit. The roots of provincial troubles go back at least 20 years, when high inflation, a reliance on centrally collected revenues and a lack of budget discipline led to continued fiscal deficits. The Convertibility Plan (1991) benefited the provincial accounts, increasing their revenues, both direct revenue and transfers. Between 1990 and 1992, total provincial revenues increased from 7 per cent of the GDP to 9.5 per cent of GDP as a result of the end of the “Tanzi effect”, better tax collection and economic growth. The overall provincial deficit (defined as net borrowing requirements) improved from 1.4 per cent of the GDP in 1990 to 0.2 per cent of GDP in 1992, but has deteriorated since then, reaching 1.2 per cent of the GDP in 1995 [World Bank (1996)]. Among the causes of the provincial fiscal crisis, institutional factors played a major role. Of these, the lack of financial discipline (inherited from the hyperinflationary years), mandated service transfers, and inadequate rules regarding accounting, reporting, and transparency were particularly important. In addition, the rapid and unexpected rise in provincial revenues associated with the Convertibility Plan led to unwise increases in expenditure, which could not be sustained when the boom ended.

The Chilean economy was deeply hurt by the oil shocks of the 1970s and the debt crisis triggered by the rise in international interest rates in the early 1980s. As a result, Chile faced a severe recession in the 1980s, with growing unemployment, declining savings and investment rates, and a deteriorating balance of payments. To overcome these problems, Chile focused its economic policy on the reduction of government intrusion in markets and encouraged the free play of market forces. By the mid-1980s the government had started to implement sweeping economic reforms, decentralizing responsibilities, improving the tax collection system, privatizing public companies, liberalizing trade and capital markets, privatizing the social security system (now completely privatized), reforming the labor market, and, most important, pushing an ambitious educational policy reform [Cepal (1998)].

In Brazil, the main source of fiscal problems has been the constitutional changes enacted in 1988. The new Constitution of

1988 caused a dramatic reduction in the revenues that went to the federal government, increasing the share of tax collections transferred to states and municipalities. In addition, the Constitution earmarked many revenue sources to specific objectives or levels of government. Also on the negative side, the new charter increased federal responsibilities – rather than reducing them, as might have been expected under the circumstances – setting expenditure floors for certain areas (such as law enforcement, cultural affairs, and education) and by granting tenure to all public employees admitted by public examination in all levels of government after two years of service. Another provision with serious budgetary consequences allowed pensions and retirement benefits to be granted, regardless of age, after a specified number of years of work, 35 years for men and 30 years for women.²

Amongst the measures recently adopted by the Brazilian government to restore fiscal discipline are several changes to the 1988 Constitution, including the provisions regulating the hiring and firing of civil servants and a comprehensive tax reform. The government has also promoted an ambitious privatization program, the reorganization of state banks, and the renegotiation of state debts. The most important ongoing reforms, which are expected to correct old and known fiscal problems in Brazil, deal with administration of the public sector administrative and the system of social security.

At the end of the 1980s government regulation was far-reaching in Colombia and the state was the director of development, protector of industry, a dispenser of subsidies, and a major provider of jobs. However, government inefficiency and the fiscal deficit increased as time went by. There was extensive fiscal avoidance and tax evasion [Torres and Sourdis (1995)]. Compared to most developed countries, the country collected only a third or less of what was due in revenue. In order to increase fiscal revenue, the government launched a tax reform, broadening the tax base, reducing exemptions and making the tax structure more equitable. The country also modernized its procurement system, aiming mainly at eliminating fraud. Major policies included the development of competitive pay for civil servants and strengthening auditing institutions. Also, a pension reform was enacted, replacing the pay-as-you-go system and defining a benefit program with a system of individually capitalized retirement accounts. Finally, Colombia made significant labor market reforms, reducing the costs of firing workers and allowing temporary employment.

Since the mid-1980s, Mexico has been engaged in a vigorous program of economic stabilization and structural adjust-

2 Furthermore, granting tenure and retirement at full pay for public employees has increased corporatism and encouraged rent-seeking amongst public workers.

Table 1
Central Government Overall Deficit (-) or Surplus (+) as a Percentage of GDP – 1988-95

Country	1988	1989	1990	1991	1992	1993	1994	1995
Argentina	-3.8	-2.6	-1.7	-1.2	-0.1	0.3	0.1	0.4
Brazil*	-8.7	-22.1	-10.4	-6.1	-14.3	-20.3	-17.7	-2.3
Chile	3.6	5.0	1.4	2.2	2.8	2.0	2.0	3.5
Colombia	-1.4	-1.7	-0.1	-0.8	-2.2	-0.9	0.9	-2.9
Mexico	-9.7	-5.0	-2.8	3.2	4.5	0.4	-0.6	-0.6

Source: IDB (1997, Table C-4, p. 233). Calculated as total revenues plus grants less total expenditures and net lending.

*Figures for Brazil refer to the Federal Governments nominal balance, as reported by Cysne (1998, p. 32).

ment. Its efforts have been often cited in the international community as a model for the reforms that Latin America should adopt in order to guarantee sustainable growth. Significant progress has been made on the macroeconomic front with the elimination of public-sector budget deficits and a drastic reduction in inflation rates. Furthermore, the government undertook important structural reforms in different areas, such as liberalization of the trade regime, establishment of current account and capital account convertibility, privatization of national banks, and a sharp reduction of government regulation of the domestic financial system [World Bank (1994)].

3.2. Decentralization

Sweeping decentralization has accompanied Latin America's movement toward democracy. By 1990, the region's 14,000 municipalities had effectively doubled their share of total public spending from the levels that predominated only eight years before. This transfer of political, economic, and administrative authority to local governments is a positive development, and was necessary to counteract the overcentralization that had developed under previous authoritarian regimes.³

In Mexico, responsibilities for providing pre-school, primary and secondary schooling and teacher training services were transferred from the federal to the state level in 1992. The Ministry of Health has also been decentralized, with the emphasis on transferring responsibilities to local governments. Decentralization in Mexico is believed to have increased the quality of educational and health services, but that has been accompanied by distortions in public spending in these two areas. According to Cepal (1998), decentralization in Mexico has favored the wealthier municipalities to the detriment of the poorer ones, thereby undermining the efficiency gains that might have been observed.

3 The obvious reason why this is a positive development is that numerous public services, such as education and health, are better provided at the local level.

In the case of Brazil, as a result of reforms in the early 1980s, public health care services were unified, national financing of health care was separated from direct service provision, and most public providers were “municipalized”. Since then, the federal government has largely limited itself to “purchasing” services from public and private entities on the basis of a fee-per-procedure schedule (the so-called Unified Health System). The new structure has created a positive incentive structure in the delivery of health care, but many problems remain unchecked. These include underfunding for provision of public health care, faulty payment systems, and a weak regulatory structure. They have engendered problems of coverage and quality and also increased considerably unit costs for the services that are actually provided. The government is currently seeking to address many of these issues in its reform program. With respect to education, Brazil seems to be only country in Latin America that has a local and state based system. The federal government, however, still retains a considerable degree of control over budgetary decisions by establishing parameters for resource allocation at the national level [IDB (1996)].

Argentina’s public sector has three levels of government: federal, 23 provinces and the municipality of Buenos Aires which has the rank of a province, and 1,100 municipalities. Provincial governments are the core of the country’s political organization and have their own constitutions as well as executive and legislative branches. The country’s consolidated public sector expenditures represented 27 per cent of the GDP in 1994. The central government contributed 55 per cent, and the provinces and municipalities the remaining 45 per cent. This makes Argentina a highly decentralized country in Latin America, where the average share of subnational governments in public expenditures is below 30 per cent [World Bank (1996)]. Furthermore, the share of the central government in public sector spending has fallen as the result of effective decentralization of education, health and other social services to the provinces. Between 1986 and 1994, the share of the central government in financing primary education declined from 34 per cent to 0.4 per cent; in sanitation, from 32 per cent to 8 per cent; in housing, from 13.5 per cent to 6.5 per cent; and in social welfare, from 66 per cent to 16 per cent. In 1994, provincial governments financed 97 per cent of primary education, 92 per cent of sanitation and 84 per cent of social welfare.

In Colombia, one of the most important fiscal reforms was perhaps the move towards decentralization, whose impetus can be mainly attributed to the country’s return to democracy [Ocampo (1996)]. The government’s objectives have been to strengthen provision of services at the local level, to increase participation in local economic growth [Rowat (1996)], and to encourage greater transparency and accountability in the provision of public services. Ocampo (1996) notes that following fiscal

decentralization, provincial governments have increasingly participated in the local development process. While there are frequent mismatches between revenues and responsibilities, there is an effort in Colombia to ensure that local governments have resources proportionate to their new responsibilities. However, strengthening institutional capacity at the local level remains a major challenge.

3.3. Privatization

The search for fiscal discipline in Argentina can be illustrated by its privatization program. At the end of 1988, federally owned public enterprises had acquired over US\$ 11 billion in external debt. Financial results for the thirteen largest public enterprises showed an operating deficit of US\$ 3.8 billion on revenues of US\$ 8.7 billion in 1989. For the first half of 1990, this operating deficit increased by 35 per cent. As a result, privatization was one of the major reforms undertaken by the Menem government. Equally important were the reform of government administration (including major changes in budgeting, staffing, salary schedules, and procurement) and reforms in the financial sector, particularly in the central bank. The privatization and reforms were implemented at the same time, beginning early in the Menem administration [World Bank (1993)].

In August 1989, the Argentine Congress approved the so-called Emergency Law, which gave the government executive authority to privatize a number of public enterprises. New laws and decrees followed for privatizing almost all federally owned enterprises and other services that might be attractive to private investors. Finally, the government closed some bankrupt or uneconomic public enterprises. The total market value of the assets sold (net of liabilities in most cases) was US\$ 22 billion, not counting the revenues of most concessions and the sale of office buildings, land, banks and insurance companies.

Legislative oversight was a major feature of privatization in Argentina. The Congress approved all major privatizations, either as part of the initial Emergency and Reform of the State Laws, which gave the executive the right to sell selected companies, or through individual laws for each company. Also, the government recognized early the need for regulating privatized utilities. In some cases (e.g., electricity and gas), this was established by law; in others, by decree. In most cases, privatizations have attempted to create competitive markets by regulatory systems that prevent firms from creating entry barriers. At the same time, the new firms are required to follow competitive procurement practices in order to restrict intrafirm purchases and transfer pricing.

The estimated annual savings from the reduction of federal government budgetary support to public enterprises is on the order of US\$ 1.5 billion, equivalent to almost half of the public sector's primary surplus. Furthermore, there also was an immediate impact in terms of tax collections, as privatized companies pay value added taxes and profit taxes, while former public enterprises rarely met their tax obligations. The two privatized telecommunications companies, for example, paid a total of US\$ 74 million in profit taxes in their first year of operation.

Public sector reform in Brazil effectively began in 1990. Among the most important steps were the privatization program, economic opening and regulatory reform (including changes in the 1988 Constitution). These reforms actually paved the way for the economic stabilization program launched in 1994 and for the second wave of complementary reforms implemented afterwards involving administration, social security, the financial system and taxation [Cysne (1998)].

The privatization program effectively took off from 1990 during the administration of President Collor de Mello. Trade liberalization was also accelerated in 1990 with a government commitment to reduce the average tariff from as high as 51 per cent to 20 per cent. Subsequent reforms included greater financial liberalization to allow the participation of foreign capital in privatization, changes in the tax system and in the labor code. The federal government obtained passage of an administrative reform bill by Congress which revokes job tenure rights for civil servants.⁴ There is also a new payroll law (the so-called *Camata Law*) which stipulates that personnel expenditures cannot exceed 50 per cent and 60 per cent of net tax revenues in the federal and local governments, respectively [Carneiro (1998)]. At the same time, voluntary severance programs, *Programas de Demissões Voluntárias* (PDVs), have been instituted at the federal and local government levels to encourage voluntary job separations. Similar attempts have been made at some public utilities and state banks. In some cases, involuntary severance programs have been put into practice [Carneiro and Gill (1997)].

The first attempt to control the expansion of public enterprises occurred in 1979 with the National Program of Debureaucratization. That program did not have much impact in terms of privatizations, but it enabled the government to exert greater control over the expansion of public enterprises. Throughout the 1980s, privatizations in Brazil were very timid since there was no real political commitment to reducing the government's role in the economy [Baer (1994)]. However, the country faced a severe recession at the beginning of the decade which considerably limited the number of potential buyers, since public enterprises

4 The administrative reform bill was first proposed to Congress in late 1996, but has been subject to several changes following negotiations between the federal government and political parties.

could then only be sold to Brazilian investors. Moreover, privatization was also constrained by the government's unwillingness to accept significant economic deregulation. The majority of the 38 public enterprises privatized until 1989 were not very large and their sales yielded a modest US\$ 723 million. During the first half of the 1990s, the Collor government launched a comprehensive privatization program and a number of other important structural changes [Pineiro (1996)]. Some 20 enterprises were privatized in the 1990-92 period, yielding about US\$ 5 billion to the government. The majority of the sales were made by auctions. Foreign participation was limited to 40 per cent of the voting capital but unlimited for the non-voting capital. Foreign capital participation had to remain in the country for a minimum of 12 years and stocks acquired by foreign investors through privatization could not be sold for two years. In 1992, however, these restrictions were either removed or reduced; the limit of 40 per cent of voting capital could be revised on case-by-case basis, the restriction on the sale of stocks was lifted, and the minimum period of foreign capital investment was reduced to 6 years [Baer (1994)].

The third wave of privatizations occurred between 1993 and 1994, with the sale of enterprises in the petrochemical, steel and fertilizer sectors. Carried out by the government President Itamar Franco, this phase was actually a continuation of the privatization process begun under President Collor de Mello. Fifteen enterprises were sold during this period and the government collected some US\$ 6.5 billion from their sale.

The fourth and current wave of privatizations began in 1995 under President Fernando Henrique Cardoso. This period differs from the others by including the concession of public utilities in the privatization program. In addition to the revenues collected from the sales and concessions in this period, there were gains from the new investment in infrastructure to reduce production costs and facilitate economic growth [Cysne (1998)]. Difficulties have emerged, however, in the quality of the services provided by the companies that were transferred to private control. This indicates that the government may have underestimated the need for adequate regulation of privatized companies and concessions. Altogether, 23 companies were transferred to private control in 1995-98, yielding some US\$ 14 billion. According to BNDES data, the privatization program was also responsible for the transferring to the private sector of US\$ 26 billion of debt of former state enterprises.

Privatization in Mexico began at the end of 1982, with some 106 small and medium-sized state-owned enterprises (SOEs) being sold or liquidated by the government between 1982 and 1990. The bulk of the 828 SOEs were divested during the Salinas presidency. Between 1983 and 1992 the revenues from the sale of SOEs totaled US\$ 21.9 billion, of which US\$ 20.23 billion was

from sales between 1990 and mid-1992, primarily commercial banks (US\$ 13 billion) and the telephone company, Telemex (US\$ 6.2 billion). The financial gains from the privatization program have been threefold: (i) a revenue of US\$ 21.9 billion; (ii) a decrease of government net transfers to state enterprises from 12.7 per cent of the GDP in 1982 to 2.5 per cent in 1991; and (iii) the additional tax revenue (35 per cent of profits) collected from the privatized enterprises. The net present value of fiscal savings from the privatization program is estimated at US\$ 3.5 billion [World Bank (1997b)].

The Mexican privatization program can be considered a success, mostly due to the clear and unambiguous political commitment of the government, as reflected in its willingness to remove all technical and legal obstacles, including amending the Constitution when necessary. Also, the program has to be viewed as part of the decision to redefine the role of the state. As such, it has been conceived not only as the sale of enterprises but also as a process to increase the participation of the private sector in activities traditionally reserved for the public sector. In addition, privatization was intended to facilitate the elimination of subsidies and bring market prices in line with opportunity costs.

Table 2 and Figure 1 provides a compact picture of the region's performance in terms of privatization between 1988 and 1997. The data confirm the outstanding performance of Argentina relative to the other countries. After being halted in 1995, privatization was resumed in both Mexico and Colombia in 1996. In the midst of political opposition, the Mexican government is now proceeding with liberalization of sectors such as telecommunications, port and airport management, and with divestiture of railways and airports and sales of minority stakes in petrochemical plants. Colombia resumed divestitures in 1996 with major sales of electricity generating plants and a bank. In Brazil, the government launched a program of sales of mining, petrochemical, ports and infrastructure firms in 1997, which yielded revenues of US\$ 65.2 billion in 1997-98 (including privatization at the state level).

Table 2
Privatization Revenues in the 1988-97 Period
(Millions of Constant 1990 US\$)

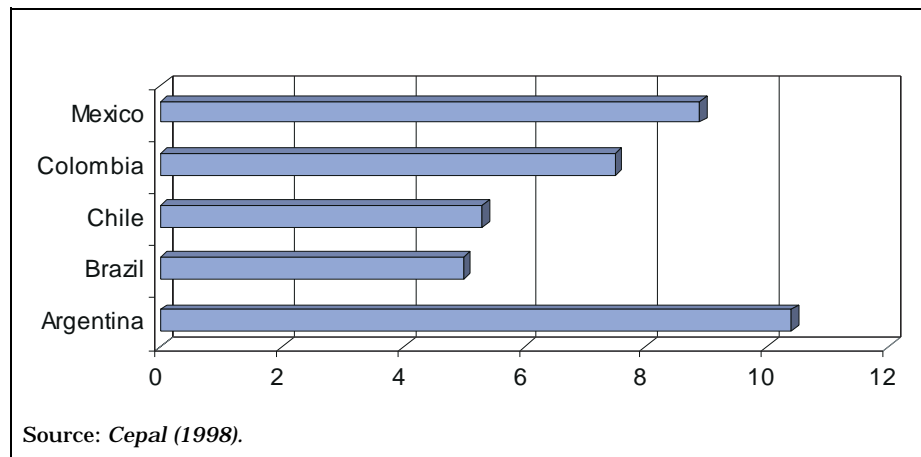
Countries	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997*	Total	Per Cent GDP**
Argentina	-	-	2,139	1,627	4,204	3,401	1,059	941	448	1,085	14,904	10.4
Brazil	-	-	-	1,662	2,495	2,445	1,470	610	3,378	8,143	20,204	5.0
Chile	526	259	42	12	8	9	413	9	339	-	1,617	5.3
Colombia	-	50	117	101	22	3	473	83	542	1,629	3,019	7.5
Mexico	-	3,580	3,580	10,108	5,768	1,802	554	165	-	-	23,474	8.9

Source: *Cepal (1998)*.

* Values estimated up to September 1997.

** As a proportion of each country's GDP in constant 1990 US dollars.

Figure 1
Privatization Revenues as a Share of GDP in the 1988-97
Period



3.4. Financial Liberalization

During most of the 1980s, financial development progressed throughout the region, as measured by the depth of financial intermediation, private sector participation in banking, and the size and activity of stock markets. The key features of financial liberalization common to Latin American countries include, *inter alia*, the opening up of capital accounts and subsequent large inflows of portfolio investment, the increased participation of foreign banks in the domestic markets, and privatization of state banks. In what follows we describe briefly major developments in the countries under review.

The main measures of financial reform in Brazil, included the creation of new credit lines for export promotion (Proex), incentives for the merging of financial institutions (Proer), and an increase in the powers of the central bank so that it might assume control of any financial institution to protect the health of the financial system. All of these measures were implemented from 1995 onwards and their cost was 3.8 per cent of the GDP [Cysne (1998, p. 54)]

In Argentina, since the Convertibility Plan of 1991, the federal government launched a concerted effort to promote structural reforms in the provinces that would be compatible with and strengthen the stabilization program at the national level. These reforms were negotiated under two agreements, the Pacto Fiscal (1992) and the Pacto Federal para el Empleo, la Produccion y el Crecimiento (1993). The provinces that adhered to the Pacts agreed to improve resource mobilization, reform the structure of provincial taxes and eliminate a series of distortionary taxes, modernize the provincial public administration, privatize public enterprises, and initiate a broad deregulation of the provincial economy. The provinces also agreed to have part of the shared

revenues appropriated and earmarked by the central government to finance specific sectors such as education, social security and urban development. In exchange, the provinces would be guaranteed a minimum floor of shared revenues, regardless of how low the national collection would fall.

Progress has been achieved in many of those areas, notably in the privatization of the provincial banks and of some public utilities, as well as the deregulation of provincial economic activities. Progress in achieving fiscal adjustment has been slower than in other areas, however. One reason is that most of the provinces did not feel the pressure to adjust and cut expenditures to a level that they could finance out of their revenues. For one thing, the provinces may not have been able to distinguish the permanent and predictable increase in their own revenues from the extraordinary one-time increase in revenues associated with the Convertibility Plan (of about US\$ 1.5 billion), due to the end of the Tanzi effect and the negotiation of common debt with the central government (of about US\$ 3 billion in 1993). For another, the incentive structure was not conducive to financial discipline, notably due to the absence of limits or conditions on provincial borrowing.

In Colombia, during the mid-1980s, as part of a concerted effort to stabilize the economy, reduce the role of the state and promote the development of the private sector, the government addressed the following policies: dismantling tariff and non-tariff barriers to international trade, liberalizing the domestic stock market, creating a propitious environment for the inflow of foreign financial capital, stabilizing the exchange rate, and public sector downsizing. The government introduced macroeconomic discipline and redirected its economic policies according to the clear principle of efficiency. Financial reforms were intended to allow markets to operate freely. Restrictions on capital transactions were softened. Reflecting the successful "capital openness" policy, capital flowed to Colombia mostly as direct foreign investment. A new banking law was issued and universal banking adopted. Capital requirements were determined according to levels of asset risk and supervision strengthened.

Major structural reforms in the Mexican financial sector were the liberalization of banking services and the privatization of commercial banks. In 1991-92, 18 banking groups were privatized, representing an inflow of roughly US\$ 12.4 billion to the government. The rationalization of Mexico's extensive system of trust funds and development banks complemented these reforms. The total assets of development banks and trust funds was reduced 46 per cent in real terms between 1987 and 1990, while staffing levels were cut by 10,000 employees over the same period. The government also reduced the implicit subsidies in the loans of development banks and trust funds from almost 1 per cent of the GDP in 1983 to less than 0.1 per cent of the GDP in 1989.

Reforms have also dramatically expanded the number of entities providing non-banking services in Mexico. Few private non-banking services were offered before 1988, aside from basic brokerage, insurance, and fund management services. Non-banking financial services other than brokerage and mutual fund management accounted for 2-3 percent of total financial assets in 1986, and there was little real growth. A series of legal and regulatory reforms were implemented during the 1988-91 period, dramatically expanding and diversifying the range of non-banking financial services that could be provided and permitting such services to be offered by financial groups. Some of the most important legal and regulatory reforms occurred in leasing, factoring, insurance, and brokerage. For instance, the real value of assets in leasing companies increased almost 200 per cent in 1990-92, and in factoring by 54 per cent in 1992. The growth in these types of non-banking services occurred for a number of reasons, the three of the most important being (1) legal reforms that modernized and deregulated existing services, and liberalized the pricing of leasing, factoring, insurance and brokerage, (2) efforts of financial groups to occupy the market in anticipation of competition from US and Canadian firms due to the Nafta, and (3) tax reforms that affected non-banking services.

3.5. Administrative Reform

During the 1990s there has been an increasing interest in state reform. Broadly speaking, the reform of the state involves (i) political aspects related to promoting good governance; and (ii) economic and administrative aspects. Administrative reform, in particular, has received increasing attention in recent years [Schiavo-Campo *et al.* (1997)].

The reason for this is the need to create a managerial state able to protect the public interest against rent-seeking activities [Bresser Pereira (1997)]. Political scientists have shown that the poor performance of the Latin American state reflects a distribution of economic and political power that biases public action in favor of the rich, squeezes the middle class, and excludes the poor. Government agencies “captured” by special interests lack the autonomy to formulate and execute policies that benefit society in general, rather than serving the narrow interests of the small elite groups that control them [Naím (1995)]. In fact, when the protection of public rights started to become a dominant concern, the reform of the state gained a new priority, ultimately leading to the replacement of the bureaucratic public administration by a managerial public administration [Bresser Pereira (1998)].

Chile was one of the countries in Latin America that implemented a successful administrative reform. In 1992, the government launched a Pilot Plan for the Modernization of Public Management whose main goal was to introduce new management

methods in the public sector. From the experience with this pilot plan, a more complete methodology was proposed to improve monitoring of public institutions. This new methodology included performance indicators, transparency rules, management contracts, performance pay, annual targets for public utilities, and a bonus scheme for institutional performance. In 1994, the government created the Inter-ministerial Committee for the Modernization of Public Management, a central agency in charge of coordinating and disseminating new management methods amongst the country's several levels of government and public agencies. According to Cepal (1998), an initial evaluation of the program of modernization of public management in Chile indicates that some 92 per cent of the proposed targets were met in 1996, with 80 per cent met in 1997.

In Brazil, earlier attempts at tackling overstaffing in the public sector have all failed due to lack of political support and/or misconceptions. The Collor government provided an emblematic example. In 1990, when President Collor took office, the new government announced an ambitious fiscal reform program that involved closure of a number of public institutions, privatization of SOEs, and the lay-off of thousands of federal public employees.⁵ In an attempt to reduce payroll expenditures by 30 per cent (about 1 per cent of the GDP), President Collor asked his ministers to cut employment by 23 per cent (a total of 360,000 workers). Additionally, some 60,000 public employees were put on reserve and received only a percentage of their salaries based on the length of service. However, all provisions regarding the elimination of public jobs were challenged in courts and had to be withdrawn following queries on their constitutionality. The net reduction in public employment was then practically null.

The government of President Fernando Henrique Cardoso is committed to public sector downsizing and has tried to encourage job separations at the federal level by means of a voluntary severance program. Previous unsuccessful attempts at laying off public workers plus stringent job security provisions make it virtually impossible to implement an involuntary separation program.⁶ The administrative reform bill was submitted to Congress in mid-1995 and was approved on June 4, 1998 in the form of Constitutional Amendment No. 19 (Emenda Constitucional N. 19). The basic directives of the administrative reform were defined in three earlier pieces of legislation:

5 Overall, the government wanted to convert an operational public sector deficit of some 6 per cent of GDP into a primary surplus of 3 per cent of GDP, calling for a fiscal adjustment of about US\$ 25 billion (at 1990 prices).

6 Currently, there are two very distinct labor regimes in Brazil. Workers in the public sector are, in most cases, admitted to service by means of a nationwide exam; these are called *estatutários* and can only be fired following an administrative process. Workers in the private sector (or subcontracted to work for the government) are under the Labor Code (*Consolidação das Leis do Trabalho* - CLT) which was enacted in 1946; these are the so-called *CLTistas* and can be fired as long as the employer pays them a penalty for unjust dismissal.

(i) Decree 1,526 of June 20, 1996 that created the Chamber of Reform of the State (*Câmara da Reforma do Estado*) which is composed of the Ministry of Administration and State Reform (Mare), the ministries of Finance, Planning, Labor, Armed forces, and the Secretary-General for the Presidency;

(ii) Decree 1,738 of December 8, 1995 that created the Council for the Reform of the State. Established at Mare and composed of prominent members of civil society, the council was supposed to evaluate critically the reform proposals suggested by the Chamber of Reform of the State; and

(iii) Base Plan for the Reform of the Apparatus of the State (*Plano Diretor da Reforma do Aparelho do Estado*), which defined the nature and scope of the administrative reform and was approved by the Chamber of Reform of the State and the presidency in November 1995.

Amongst the main features of the administrative reform are provisions providing for a complete revision in the tenure rules for public employees and the rules for appointment of new civil servants.⁷ Other measures that have also been proposed are (i) a ceiling for the highest salary in the public sector, (ii) the abolition of vacant positions that exist in the federal administration, (iii) the suspension of all public examinations which had not been previously approved by Mare, and (iv) subcontracting of support activities. All these measures are expected to reduce government spending on personnel and improve the government's capacity to manage its wage bill.

The government has abolished automatic tenure for civil servants. Only workers with more than three years of continuous work for the government will be eligible for tenure and it will also be based on a periodic review of performance. The government has also proposed laying-off all non-tenured public employees (those with less than 3 years of continuous work entered the public sector without passing a public examination), the suppression of federal transfers to states and municipalities that do not respect the limits established by the Camata Law for expenditure on personnel, and ending all financial assistance for payroll expenses to states and municipalities in difficulty. These measures should encourage state governments to reduce payroll expenditures voluntarily by employment cuts and/or salary reductions (by establishing ceilings for state remuneration, for example).

The administrative reform also provides for the decentralization of public services, the creation of regulatory agencies, and a wider use of management contracts for the provision of public services by private parties. It is hoped that these measures will

7 For a detailed account of the administrative reform process in Brazil, see Carneiro (1998).

help to improve the quality of public services, increase accountability in the public sector, and reduce the fiscal burden on all levels of government. Actually, the whole administrative reform represents the consolidation of a managerial approach to public administration.

By 1990, Argentina started a broad program of administrative reform that included a reduction of 50 per cent in central government personnel [see Schiavo-Campo *et al.* (1997)]. Some of the circumstances that led to this reform effort and the measures adopted to tackle the problem of overstaffing have some similarities with the case of Brazil. During the 1970s and 1980s, public employment grew continuously in Argentina, reaching 1.9 million by 1989. At the same time, government revenues declined and fiscal deficits increased substantially. The government then managed to pass the Laws for Administrative Reform and Economic Emergency, which provided the necessary legislative framework to undertake the reforms. Two measures were taken to reduce personnel levels: (1) a program of voluntary retirement which some 10,000 public employees accepted, and (2) adoption of a vacancy freeze which was quite effective in freezing the size of the government work force.

In early 1996, the Argentine Congress approved a law for the Second Reform of the State. This law gives the government the authority to eliminate or reorganize existing institutions (except financial institutions, universities, and regulatory agencies), to eliminate positions, and reduce the number of public employees, including in the military. Also, a fund was created to finance severance payments and training on a temporary basis. As in the case of the Brazilian administrative reform, the objective of this second reform of the state is to improve efficiency in public services and reduce public expenditure. The main actor in charge of implementing the reforms and obtaining political support, along the lines discussed earlier in this section, is the Office of the Chief of the Cabinet of Ministers.

4. Concluding Remarks and Pending Issues

Moves towards decentralization of public services comprise an undisputed trend in Latin America at the present time. Governments are searching for more efficient operation of markets with minimum participation of the state. Yet, paradoxically, this has been seen as a factor contributing to the organizational crisis of the public sector. In the long run, political and administrative decentralization offers the only hope for improvement of activities that are better managed at the local level. In the short run, however, the decentralization has frequently led to a decline in the performance of the public sector [Naím (1995)].

As a result, an issue facing the region appears to be the creation and development of the institutions needed to support the new economic policies (e.g., regulatory agencies, antitrust and antidumping commissions, consumer protection agencies, etc.). Even more challenging will be the upgrading of existing public agencies, devastated by decades of neglect, underinvestment and rent-seeking practices. Furthermore, reforming governments in the region will have to be concerned about the need for sophisticated public management in a context of growing, and sometimes extreme, "reform fatigue".

By the same token, financial liberalization in Latin America has advanced more quickly than improved financial supervision and prudential regulation. Moreover, the countries have been left exposed to greater risks of financial crises, which they should try to prevent, partly by seeking to reduce the potential for macroeconomic instability, and partly by a deepening of the financial reform in the domains of regulation and supervision.

Advances in privatization have been very uneven in the region: first, because of the political constraints and opposition from labor that privatization generally encounters; and second, due to the need to follow a sequence that would assure the success of the process from the standpoint of economic efficiency. Therefore, further privatization in the region should be preceded by the creation of a regulatory framework separating potentially competitive activities from those with natural monopolies, setting up rate systems, defining spheres of activity and purposes of the companies, and creating oversight agencies. When that is not possible in the short run, steps should be taken to at least privatize the management of companies through management contracts, concessions or subcontracts.

As far as labor legislation is concerned, modernization seems to be a challenge for almost all countries in the region. Labor code reforms have been few and not very deep and, as a result, current labor legislation may have hindered the reabsorption of workers displaced during the reform process. The agenda for future reforms in this area therefore should contemplate measures to increase labor demand. Examples that could be followed are those of Colombia and Brazil, which have encouraged temporary hiring of workers, increasing labor market flexibility in periods of declining economic activity. Another general recommendation concerns the reduction of rigidities imposed by collective bargaining norms and conventions inherited from the past, which are usually applied to a whole sector or branch of industry. International evidence suggests that these institutional arrangements are the least conducive to good macroeconomic performance, due to the power they give to the bargaining parties to the detriment of society. The idea is, therefore, to seek a complete decentralization of wage bargaining, bringing it closer to the plant level.

The challenges for the future are similar for all countries of the region. The cross-country experience presented in this paper just highlights them. The political priority given to resolving the problems caused by high indebtedness, macroeconomic imbalances, and excessive state intervention in the 1980s should now be given to finding ways to alleviate the consequences of institutional decay and the contraction of the state. Reforming governments should be aware that state-dominated development has failed, but stateless development is impossible.

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