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**The State and the Private Sector in Latin America:  
Reflections on the Past, the Present, and the Future**

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**The State and the Private Sector in Latin America:  
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The role of the state, private domestic firms, and foreign firms has changed substantially in recent years throughout Latin America's economies. An almost universally accepted goal in the 1990s seems to be to reduce the presence of the state in the region's economies, to reduce state regulations, to encourage the growth of the private domestic sector, and to welcome the participation of foreign capital not only in manufacturing industries, but also in areas reserved for the state for the last half century (such as public utilities and the exploitation of natural resources).

This is quite a change from the mood that prevailed in most of Latin America during the heyday of import-substitution industrialization (ISI) in the three decades following World War II. Then, state firms dominated public utilities, the exploitation of natural resources, and some basic industries (like petroleum refining and steel), and was a prominent player in banking, petrochemicals, and some other industries. A longer view, however, reveals that the current privatization thrust might not be a 180- but rather a 360-degree swing, since in the early decades of this century the private sector (especially foreign capital) was dominant in extractive industries and public utilities.

We shall first review the role of the public and private sectors in distinct periods of Latin America's development—the pre-ISI period, when primary exports were the leading sector; the ISI period, which spanned the period from the Great Depression of the 1930s to the 1960s; and the two decades (the 1970s and the 1980s) when the region suffered external (oil prices and interest rate) shocks, became heavily indebted, and then stagnated during the debt crisis decade of the 1980s. We shall then examine implications of the privatization trend in Latin America—its promises and pitfalls, its implication for a new state role in the economy, the extent to which it will require a more open economy, and its implication for a new growth model for the region.

### **The Period of Primary-led Export Growth**

During the rapid expansion of world trade that began in the latter part of the nineteenth century and lasted until World War I, the Latin American economies became specialized in the exportation of primary goods. Most countries of the region relied on a small number of food products and/or raw materials for their foreign exchange earnings, and most imports consisted of manufactured products. The production of exportable goods was undertaken by the private domestic sector (e.g., coffee in Brazil, grains and livestock in Argentina) and by the foreign sector (e.g., copper and other minerals in Chile, Peru, and Mexico; petroleum in Mexico and Venezuela; plantation agriculture in Central America, Peru, and Colombia). Foreign firms also often dominated commercial operations surrounding these exports. In addition, a substantial amount of foreign investment went into infrastructure, such as railroads, urban transportation, power generation and distribution, and the telephone system. The direct involvement of the state was relatively small, though in several cases it assumed direct ownership of railroads, which were constructed with foreign financing.<sup>1</sup>

The state provided a favorable atmosphere for private investment in that period. For instance, it often guaranteed a rate of return for foreign companies that invested in railroads; or taxes were relatively low on foreign firms investing in primary export sectors. Regulations were at a minimum and, where they existed, especially in the public utilities sector, they were usually favorable to foreign firms.

During most of this period the region had a free trade regime. Most import tariffs existed to raise revenues and were not protective in nature. Where the private sector was unwilling to enter, especially in providing credit to the agricultural sector, the state in a number of countries established banks. And in the provision of social services—health and education—the state's presence was relatively weak (there were some exceptions, such as the large investments in Argentinian education in the latter part of the nineteenth century). Of course, the population was mainly rural, which meant that the pressure for the provision of social services was relatively weak.

### **The ISI Period: From the 1930s to the 1960s**

The presence of the state grew rapidly in this period. Earlier in the century some governments had bought out railroads, as they were unwilling to continue to guarantee a rate of return to foreign enterprises. The depression of the 1930s, however, marked the beginning of a more active state in the economy. Controls began to proliferate—

exchange controls, direct foreign trade controls, controls over tariffs charged by public utilities, production and marketing controls of agricultural and other primary products. By the late 1930s Mexico had nationalized its petroleum and some mining sectors. This nationalization served as a precedent for the nationalization of the petroleum and mining sectors in other countries of the region during the 1950s and the 1960s. Nationalist governments felt that control over nonrenewable resources should be in the hands of the state.<sup>2</sup>

The growing government takeover of public utilities—railroads, power generation and distribution, telecommunications, and so on—was in part the result of government perception that these strategic sectors should be in the hands of the state. It was also the result of public utility tariff controls, which did not allow for adequate rates of return for their foreign owners. The latter were thus unwilling to make investments that would serve the needs of rapidly industrializing and urbanizing countries. The state therefore felt it necessary to nationalize public utilities, and the new state firms in these sectors received the necessary subsidies to modernize and expand power generation and distribution, telecommunications, and the like.

The adoption of ISI as the principal development strategy not only led many governments to expand their public utilities, but also established state-owned firms in a number of basic industries, especially in the steel, metallurgical, and petrochemical sectors. The motivation was partially nationalist, but also was due to the fact that neither domestic nor foreign private firms were willing to pour large amounts of money into projects whose gestation period was relatively long. Finally, through the establishment of development banks (such as Brazil's BNDES, Mexico's Nacional Financiera, and Chile's CORFO), Latin American governments became important players in influencing the direction of investment resources and in influencing the private sector either through financing operations or through shareholder participation.

The ISI period witnessed a dramatic change in the role of foreign capital in the region's economies. Most Latin American governments realized that neither the domestic private sector nor the public sector had the technical and financial capacity to establish ISI industries rapidly. It was thus important to induce foreign firms to establish subsidiaries in new import-substituting sectors. This was achieved through a policy of protection, which was complemented by special inducements—such as tax holidays, and the permission to import machinery without foreign exchange cover.

Manufacturing, rather than public utilities, mining, and agriculture, thus became foreign capital's major field of operation.

The private domestic sector was not neglected in this period. It also benefited from protection and received subsidized loans from government development banks and other favors. In a number of countries there was an emphasis on rapidly increasing the vertical integration of new sectors. Thus multinationals were encouraged to make or buy components in the country. Domestic firms often became suppliers of multinationals and in the process acquired new technological capacities.

For a while during the ISI process the state, the domestic private sector, and private foreign firms worked together. They complemented and therefore strengthened each other. The presence of the state in this period "crowded in" rather than "crowded out" the private domestic and foreign sectors.

### **Origins of the Decay of Public Enterprise: The Crises of the 1973–1991 Period**

The debt and inflation crises of the 1970s and the 1980s contributed significantly to the decline in the dynamism and efficiency of public sector firms and, over the course of almost two decades, many became a liability to the government.<sup>3</sup> In Mexico the deficit of public enterprises as a proportion of total public sector deficit was over 100 percent in the second half of the 1970s (i.e., the deficit of public enterprises was larger than the total public sector deficit, since the public sector, excluding public enterprises, showed a surplus). In Brazil public enterprise revenues as a proportion of GDP averaged about 16 percent in the first half of the 1980s, while expenditures averaged about 18 percent.<sup>4</sup> The oil shocks of the 1970s forced many Latin American policymakers to choose between slowing economic growth to adjust to new international prices or borrowing to finance the continued expansion of their economies. Many governments chose to pursue continued growth and public enterprises were used to capture foreign resources.<sup>5</sup>

In the 1970s, Latin American public enterprises began borrowing from commercial banks rather than from the multilateral development banks, which had been their prime source of foreign capital in the previous decade. As the economic crisis wore on in the industrialized countries and international interest rates became sharply positive, many Latin American countries became increasingly desperate to obtain foreign exchange to meet their rapidly growing debt servicing needs. They turned to their public enterprises

to attract additional external finance. Many state enterprises had a good reputation in international financial markets at the time and were forced by their central governments to borrow more money than was needed for their investment plans. Thus, by the 1980s many state firms had huge foreign debts whose servicing placed them in a precarious financial situation.

Public enterprises were also used by central governments to address the rising costs of inflation. Many Latin American governments began to use state enterprises as macroeconomic stabilization instruments. To this end, prices of steel, electricity, water, and telephone and transportation services were not allowed to accompany the general rise in the price level, but were forcibly frozen or allowed to rise at only a modest rate. In Brazil, for instance, the real prices of iron and steel products (a sector dominated by state enterprises) declined by 50 percent between January 1979 and December 1984; of electricity tariffs, by 40 percent; and of telephone tariffs, by 60 percent.<sup>6</sup> In Mexico, producer prices in the private sector increased more than 122 times between 1980 and mid-1990, while public enterprise prices increased by less than a factor of 110.<sup>7</sup> If petroleum prices are excluded, however, the prices of other Mexican public enterprises rose faster than private sector prices. One has to consider, however, that the state-controlled Mexican petroleum sector dominated state enterprises and had an enormous weight in Mexican price formation. While public enterprise prices were held down to help control the general increase in the price level, the policy destroyed the financial position of the enterprises.

The use of public enterprises to capture foreign financial resources and provide macroeconomic stability undermined their microeconomic efficiency and identity firms. It also ultimately worsened the central government deficit. To the extent that a firm's losses were covered by government subsidies, they contributed to the increase in general government expenditures, to the government deficit (assuming that such subsidies could not be covered by increased taxes), and thus to further inflation. In addition, to the extent that the financial losses of state firms resulted in a curtailment of investments, their efficiency declined further and so did their capacity to increase total output.

As public enterprises became less like firms and more like macroeconomic policy tools, the opportunity for economic and political abuse expanded. Where state firms were the sole producers of certain products that were crucial inputs for private firms, deliveries were often late unless an "urgency tax" (bribe) was paid. Or, where the

private sector had state firms as the major customers, payments were often delayed beyond the time stated in contracts, unless side payments were made to obtain a quicker release of the money. Such monopolistic abuses increased the private sector's costs and thus reduced the general efficiency of the economy.<sup>8</sup>

The use of public enterprises for attaining certain distributional goals has also contributed to the weakening of their microeconomic position. The control of public utility prices to favor lower income groups or productive sectors of the economy that the government wished to promote contributed to lower profits or increased losses of public sector firms. Of course, such losses could be subsidized by the state through higher taxes, but this was often politically impossible. The only feasible option for the government was to subsidize the firms, adding to its own budget deficit, or not to subsidize them and allow the firm's effectiveness in attaining its original goals to be diminished.<sup>9</sup>

While the use of public enterprises for macroeconomic policy objectives may have had negative repercussions for the financial health of the firm, the benefits of their use might be thought to have outweighed the cost. The abuse of public enterprises for political purposes, however, has had a more decidedly negative effect. Under military governments, many Latin American public enterprises undertook grandiose projects whose scale were overwhelming and usefulness questionable. With the redemocratization of most Latin American countries in the 1980s, pressures to increase employment beyond the needs of the firms or to hire executives whose qualifications are more political than technical are increasing. There may also be pressure on public enterprises to locate public firms' new investments in politically desirable rather than in economically optimal places.<sup>10</sup> Such political interference substantially reduces the efficiency of public firms and demoralizes their professional staffs. Of course, under authoritarian regimes such abuses also took place. Moreover, under such regimes, there was usually no free press to investigate and expose abuses in the use of state enterprises.

### **Trends in the 1990s**

The ISI strategy has outlived its usefulness, the debt decade of the 1980s is finally over, and an era of liberalization and privatization is well under way throughout Latin America. A new consensus regarding the role of the public and private sectors is beginning to emerge, based on several new trends and developments. A further

examination of these new regionwide developments will help set the stage for a glimpse into the future in Latin America for the rest of the 1990s.

### *Gradual Opening of Borders*

Latin America cannot export more without more efficient firms, and efficiency can be achieved only by having firms, which previously operated in a protected market, become exposed to international competition. This had led to a gradual opening of borders, with nearly all governments now allowing more imports of more modern technology. This opening has benefited local consumers and has also led to more exports by local industry. The conventional wisdom of the 1980s was that Latin America could not afford to allow more imports because it needed to generate trade surpluses to service the debt. Now it is recognized that governments cannot afford to keep their borders closed and that more imports will lead to more exports and a higher standard of living.

This gradual opening of borders has also helped revive discussions about regional trading blocs, such as MERCOSUR and the Andean group. They may be transformed from the impossible dreams of the 1960s into realities in the 1990s. But it may not be enough, as we shall see shortly.

### *Privatization of State Enterprises*

The objective of most countries today is to withdraw the public sector from most productive activities, and some countries are even aiming to privatize public utilities (this has already occurred in Argentina, Chile, and Mexico). By withdrawing from direct participation in most economic activities, the state may be able to reduce the deficits that led to the borrowing and inflationary spiral of the 1970s and the 1980s.

As the case studies in the Property Rights, Privatization, and Regulation in Latin America conference reveal, privatization is being carried out in a variety of ways. Some state firms are being privatized through sales to foreign firms (both public and private), often involving debt-for-equity swaps. The immediate benefit of such privatization is to provide additional income to governments, which underwent a substantial fiscal squeeze throughout the 1980s. Although the sale of government enterprise involves only a one-time income for the state, it also reduces longer-term government expenditures by reducing the debt servicing usually required and freeing the state from having to provide subsidies to loss-making state enterprises.



### *Deregulation of Local Industry*

While opening of borders and privatization have grabbed most of the headlines in recent years, there has been another important trend. Governments have been gradually reducing their control over the daily activities of firms. Price control boards have been abolished, import permits for many goods have been eliminated, and governments no longer set wage policies (often because they no longer own the enterprises that used to be the trend setters in wages).

### *The Growth of the Informal Economy*

This trend began in the 1970s, as many people became informal entrepreneurs operating outside of the formal economic system and usually earning only subsistence wages. This was a response to the stifling control of the state. Many call it the first move toward privatization, as these entrepreneurs began their activities in areas in which the state enterprises and government did not perform effectively. In the 1980s, the informal economy served as a safety net for individuals left without jobs during the recession of that period. The challenge for the 1990s is to incorporate them back into the formal economy.

### *The Emergence of Three Major Trading Regions*

Europe '92 has already led to nearly complete trade liberalization within Western Europe and rationalization of many industries. Now trade and investment have been expanded to include Eastern Europe as well. The vision of a European trading region is quickly becoming a reality. In Asia, Japan has quietly led the formation of an equally powerful trading region, which includes Korea and South Asia today, and which may include China in the future. Japan's huge industries have invested massively throughout the region, and trade is based more on company-to-company trade than on government-to-government cooperation.

North America is close to forming the North American Free Trade Agreement (linking Mexico to the United States and Canada), so other countries in Latin America may have to decide whether to join the North American trading region (and open their economies even further) or attempt to trade with all regions. Countries like Chile and Venezuela have already decided to link their future more closely with North America. But Brazil and Argentina, with their closer ties to Europe, are more reluctant to decide, and so have focused on the more modest MERCOSUR.

*Challenge for the Future: An Effective Post-ISI State*

While Latin America has undergone its most far-reaching structural changes in the last sixty years, the world around it has been changing even more rapidly, making the changes in Latin America seem modest or even timid in some countries. Other countries have opened their borders more completely and privatized their industries more rapidly.

Latin American governments no longer have the funds to invest directly in order to spur growth and development, so they must attract investment into the region. But in the present world circumstances, they have to compete for those investments funds against other regions and governments with longer and more successful performance records.

The old ISI strategy has been replaced by these new thrusts based on opening of borders and privatization. While these changes were necessary in order to correct the problems of past decades, they are not sufficient for the 1990s. The role of an effective post-ISI state is still to be defined and delineated. The focus of most states in the 1990–1992 period was to tear down the old state, with less attention given to construction for the 1990s. The elements of that new role, however, are beginning to emerge:

1. state investment in social infrastructure, especially health and education, and the creation of a minimal social safety net for all of its citizens;
2. creation of a broader and more equitable tax system, which allows more money to be collected more equitably and avoids the temptation to return to the inflationary finance so widely used in the past;
3. the state as a regulatory agency for public services and natural monopolies. Although the state no longer owns most of the industries that provide most public services, it faces the same challenges that were so difficult to resolve one hundred years ago—how to regulate public transportation, telephones, utility companies, and so on, and balance the conflicting needs for low-cost public services versus reinvestment in these areas based on a reasonable profit. It is not clear yet who the regulators should be and how they can be protected from undue pressure from interest groups. Are the regulatory models of the United States, or the European countries, or Japan relevant to the institutional situation of the Latin American countries?

4. encouragement of rather than ambivalence toward foreign investment. In a privatized and open economy, the treatment of foreign capital has to be devoid of the type of special controls that nationalistic forces exercised after World War II, but also of the special deals of the nineteenth century, which often amounted to exploitation;
5. encouragement of local capital to stay in the country. The liberalization of recent years has attracted a substantial amount of flight capital back to home countries, especially to Mexico, Chile, and Argentina. Some of this capital has been invested in state firms that are being privatized, but much of it has been invested in regional stock markets. Governments now seem to recognize that, if they cannot persuade their local investors to keep their money in the country, they will not be successful at attracting foreign capital, which has become a centerpiece of their development strategies;
6. formation of regional capital markets. While flight capital has led to the recent boom in local stock markets, the development of these capital markets is crucial to long-term development. Government regulation must stop insider traders from making speculative profits by manipulating markets. This will give more investors the confidence to increase their investments and make regional capital markets a magnet for foreign capital;
7. more equitable distribution of income. None of these new policies will be successful or sustainable unless governments can reverse the record of the last twenty years in which the rich got richer and the poor got poorer. This may also imply a change in the behavior pattern of the Latin American private sector in relation to the state. A way must be found to "privatize the private sector," that is, to develop state institutions, both regulatory and credit, that cannot easily be captured by powerful special-interest groups.

While increased state investment in health, education, and a social safety net will help and a more equitable tax system can finance these investments, these steps will not be enough. Many governments will move toward a European rather than an American role for the state, that is, a state that is active in pushing for basic social programs and in offering guidance to industrial developments. This must mean a stronger role for private firms, in cooperation with government, in providing social services for their employees and communities. Better-educated and -trained workers

help their firms to become more competitive, but they also become more effective citizens who provide better education for their children.

Latin America can feel justifiably proud of finally returning to a period of growth, after a grim period during the past ten years; however, a sustained economic recovery based on the twin pillars of liberalization and privatization will be successful only if the poorest segment of the society is more fully incorporated into the economy.

The post-ISI state, only now beginning to emerge, must focus on the development of all of its citizens by focusing on its new role. It must augment and improve the provision of health, education, and other social services, and it must encourage the private sector to be a more proactive partner in this challenge for the 1990s.

## Notes

1. For a more detailed description of this period, see Glade (1969), chaps. 6–9.
2. A more thorough description of the growth of the state during the ISI process can be found in Baer (1974; 1989, chap. 11).
3. This section is based on a paper by Baer and Birch (1993).
4. For Mexico, see Ferrer (1991), p. 43; for Brazil, see Baer (1989), p. 129.
5. Public enterprise managers might argue that it was during this period that their owner, the central government, became a liability to them. Being forced to borrow beyond their needs and their capacity to service debt interfered with their autonomy and their microeconomic objectives.
6. Werneck (1986), pp. 566-567.
7. Banco de México, *Índices de precios*, table III-15 (July 1990).
8. For more detailed discussion of monopolistic abuses of state enterprises, see Villela and Baer (1980).
9. Another example is the case of a government firm like Mexico's CONASUPO, which was established to "raise and stabilize income in the rural areas through purchases of agricultural products and to provide subsidized retail outlets for the sale of basic goods to low-income consumers" (Hill [1984], p. 385). The inevitable deficit of this organization had to be covered by the state through either taxes, or decrease in other expenditures or an increase in the government budget deficit.
10. Not much of this happened in the 1980s because of the depressed economic conditions in Latin America, which forced a drastic decline of new investment projects. But that such forces exist is shown by the fact that in democratic times the location of investment projects like Brazil's Volta Redonda steel mill or the petroleum refineries of state enterprises throughout Latin America were in part determined by regional political interest groups.

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