
REVIEW ESSAYS

PERFECTING REFORM IN LATIN AMERICA: What Role for the State?

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- COMPETITION POLICY, DEREGULATION, AND MODERNIZATION IN LATIN AMERICA.* Edited by Moisés Naím and Joseph Tulchin. (Boulder, Colo.: Lynne Rienner, 1999. Pp. 293. \$55.00 cloth.)
- GROWTH, EMPLOYMENT, AND EQUITY: THE IMPACT OF THE ECONOMIC REFORMS IN LATIN AMERICA AND THE CARIBBEAN.* By Barbara Stallings and Wilson Peres. (Washington, D.C.: ECLAC and the Brookings Institution, 2000. Pp. 252. \$22.95 cloth.)
- THE IMPACT OF PRIVATIZATION IN THE AMERICAS.* Edited by Melissa H. Birch and Jerry Haar. (Coral Gables, Fla.: North-South Center Press, 2000. Pp. 256. \$26.95 paper.)
- THE POLITICS OF TELECOMMUNICATIONS IN MEXICO: PRIVATIZATION AND STATE-LABOR RELATIONS, 1982-1995.* By Judith Clifton. (New York: St. Martin's, 2000. Pp. 277. \$69.95 cloth.)
- PRIVATIZATION SOUTH AMERICAN STYLE.* By Luigi Manzetti. (New York: Oxford University Press, 1999. Pp. 373. \$74.00 cloth.)
- REFORMING THE REFORMS IN LATIN AMERICA: MACROECONOMICS, TRADE, FINANCE.* By Ricardo Ffrench-Davis. (New York: St. Martin's, 2000. Pp. 232. \$65.00 cloth.)
- REGULATORY POLICY IN LATIN AMERICA: POST-PRIVATIZATION REALITIES.* Edited by Luigi Manzetti. (Coral Gables, Fla.: North-South Center Press, 2000. Pp. 301. \$55.00 cloth.)

Public discontent with the social, political, economic, and environmental consequences of the expanding interconnections among national economies has become increasingly evident worldwide in recent years. Concerns in the advanced industrial countries about the impact of free trade on

unemployment, labor, health, and the environment helped to scuttle the initiation of a millennium round of world trade negotiations in 2000. Similar concerns have inspired a growing number of global activists to protest "the dark side of globalization" by attempting to disrupt the meetings of international organizations associated with promoting market forces and deeper global economic integration. Protesters have become a ubiquitous and increasingly disruptive presence at the meetings of the World Trade Organization, the International Monetary Fund, the World Bank, and the World Economic Forum. In developing regions, citizens are finding that the market reforms implemented during the 1990s are not paying the dividends promised by their governments. Rather than promoting stable economic growth and creating opportunities for improved living standards, such reforms have been associated with financial crises, expanded inequality, increased unemployment and job insecurity, and stagnant or declining living conditions for the majority.

This trend is also evident in Latin America. Market reforms successfully stabilized economies suffering from extremely high inflation and plunging exchange rates, a feat that translated into initial popular support for the reform process throughout much of the region. But the ensuing years seem to have witnessed more of the shortcomings of the reform process than the expected advances. Collusion and even corruption in the privatization process produced high prices, often poor services, and weak banking systems. Poorly capitalized financial sectors and macroeconomic mismanagement led to deep devaluations and financial crises. And job losses in the public sector, growing economic inequality, and little progress against poverty have fueled a sense of increased economic insecurity in society. The overall consequence has been a tangible weakening of popular support for market reforms.

Growing dissatisfaction with the limited benefits of reform are evident in the strikes and protests that have repeatedly paralyzed Buenos Aires in recent years and in the violent protests that have erupted in many interior provinces. For Argentines, market reform seems to have delivered economic stability at the price of repeated and prolonged recessions, persistently high unemployment, declining living standards, and increased corruption and crime. In Mexico the bankruptcy of privatized banks and toll roads and the ensuing government bailout have convinced most Mexicans that privatization has undermined their economic well-being rather than enhancing it. In conjunction with the sense of economic insecurity generated by repeated economic crises during the 1980s and 1990s, these failed privatizations have produced doubts in Mexican society about the wisdom of relying on the market and have fed pockets of radical anti-reform sentiment, from guerrilla movements in the southeast (the most famous being the Ejército Zapatista de Liberación Nacional or EZLN) to student movements in Mexico City

(responsible for closing the national university for nearly a year). Discontent with the recent performance of the Brazilian economy has helped to undermine public support for the government of Fernando Henrique Cardoso and reinforced Brazil's traditionally heterodox approach to economic management. The mere proposal of major economic reforms in Ecuador helped solidify the opposition to President Jamil Mahuad in late 1999 and gave rise to the coup that ousted him from office and nearly toppled Ecuadorian democracy the following January. And in Bolivia, 2001 was marked by a series of marches protesting the market economics that appear responsible for slowing growth, rising unemployment, and declining living standards. Meanwhile, the anti-market rhetoric of President Hugo Chávez in Venezuela continues to enhance his popularity. Only in Chile, where economic reforms were able to meet popular expectations for growth and improved living standards (at least until the 1999 recession), does the market model of development enjoy significant popular support.

The clear failings of market reforms in Latin America and beyond have led some to conclude that the world should abandon reliance on capitalist markets as the source of growth and development. These increasingly vocal activists have revived the argument that the market by nature is fatally flawed and thus incapable of delivering stable and equitable growth anywhere on the globe, least of all in developing regions. The state should therefore reassert itself and get back into managing the operations of the market economy to overcome the bias of the market toward instability, inequality, and environmental degradation.

Few analysts are willing to go this far, and most Latin Americans do not pine for a return to the era of protectionism and heavy state intervention in the economy that led to hyperinflation and the lost decade of the 1980s. Yet growing disillusionment with the market model is palpable in Latin America. Such disappointment could easily become fodder for populist politicians who blame unrestrained market forces for Latin America's woes and promise the moon and the stars from imposing significant restraints on the market. Until and unless market reforms begin to deliver on their promises, their survival in Latin America cannot be assured. Only the reforms' success can ensure popular support for their perpetuation.

How then can the reforms be made to work better? How can the real potential of the market to create wealth and economic well-being be unleashed in Latin America? And how can the evident shortcomings of the market be overcome? What is the appropriate mix of policies that can produce the economic growth and rising living standards that are fundamental to developing a regional store of confidence in the economic benefits the market can provide? This sense of confidence is an essential prerequisite for the long-term survival of market economics in Latin America. The seven works to be reviewed in this essay offer some help in answering these ques-

tions. They also provide insights into understanding better what has gone right and what went wrong in Latin America, and how the countries of the region might improve the performance of their market economies.

Taken as a whole, this literature leads readers to a major yet far from earth-shattering conclusion: the weaknesses in economic reform emanate from both economic and political sources. As opponents of the market argue, markets cannot produce positive outcomes unless they are complete and competitive, conditions commonly not prevailing in Latin America. And as supporters of the market argue, government involvement in the economy produces rent-seeking and other inefficiencies driven by the logic of political survival. The policy challenge for Latin America is to find a way to minimize both market and government failures and thereby maximize the benefits for growth, equity, stability, and sustainability. As the works under review make clear, this undertaking is an essential but daunting task.

Government Failures versus Market Failures

The debate among economists regarding the main source of economic inefficiency—government failures or market failures—stretches back for more than two hundred years, and there is still no agreement. Economists of all stripes agree that government involvement in the economy adds a political calculus into market operations that is inevitably inefficient economically. State intervention also invites economic actors to rent-seek, that is, to seek special favors from the government that will benefit themselves at the expense of the rest of society. It is further agreed that when markets are incomplete or where structural obstacles to market operations exist (such as limited resource mobility, price flexibility, response capacity, or perverse expectations among economic agents), markets cannot operate efficiently. Yet no consensus has emerged on how to respond to these dual sources of inefficiency in capitalist markets. Classical economists since Adam Smith have insisted that any effort to employ the government to reduce the costs of market failures will merely aggravate the situation by introducing an inevitably greater source of inefficiency: government failures. Structural economists argue that the extent of market failures is such that government intervention is essential to the efficient operation of markets.

The classical economists appeared to have won this battle in the wake of the spectacular implosion of the structuralist-informed import-substitution model of development in Latin America. Yet structural economists did not disappear. The collapse of import-substitution industrialization clearly chastened them and forced them to take a long, hard look at the unmistakable role of government failures in this fiasco. But they never wavered in their insistence that market failures demand government action if markets are to operate efficiently. Although structuralists now agree wholeheartedly that a sharp reduction in the role of the state in production and

economic decision making was essential for the improved operation of the market in Latin America, they complain that the overwhelming emphasis placed on the problem of government failures during the reform period blinded policy makers to the equally grave threat posed by market failures. *Reforming the Reforms in Latin America: Macroeconomics, Trade, Finance* by Ricardo Ffrench-Davis is the latest contribution to the elaboration of this “neoliberalist” vision of economic policy in Latin America.¹

This collection of ten essays published by Ffrench-Davis during the 1990s argues that the disappointing performance of the Latin American economies in the last decade can be explained by overconfidence in the capacity of the market to create growth and efficiency. Echoing his ECLAC colleagues, Ffrench-Davis accepts that the sharp reduction in the economic role of the state had a significant positive impact on market efficiency. Yet in ignoring the persistence of pervasive failures in Latin American markets, this strategy was insufficient to produce sustained growth.

Ffrench-Davis directs his analytic attention toward trade liberalization and particularly the liberalization of capital flows where incomplete markets predominate. He argues that the liberalization of capital flows in the presence of weak and shallow domestic capital markets produced a bias toward investment in consumption and speculation rather than in capital formation. Limited investment in new production facilities meant that the initial spurt of growth produced by macroeconomic stabilization, based on the reemployment of idle production capacity, was unsustainable once this production capacity was fully employed. What states should have done was manage the liberalization process to direct capital toward productive investment. This goal could have been achieved though the use of limited and selective capital controls to encourage long-term, productive investments instead of speculative flows (Ffrench-Davis is aware that capital controls carry costs—they will discourage some capital inflows and markets will find ways to evade them—but he insists that the costs of doing nothing can be significantly larger). Additionally, states should develop special-

1. The debate among economists regarding the best economic strategy for promoting growth in Latin America extends beyond this neoclassical-neoliberalist dichotomy. Strictly speaking, the third school of thought is the neo-Keynesian approach. Neoclassical economists argue that the best policy mix for Latin America is to privatize and liberalize and let the market take care of itself. Neo-Keynesians argue that Latin America should privatize, liberalize, and regulate because markets need government intervention to help complete incomplete markets and to ensure the competitive conditions that help mitigate other kinds of market failures. Neoliberalists insist that Latin America must privatize, liberalize, and intervene directly in market operations because market outcomes do not address inequalities effectively. Based on this typology of economic strategies, ECLAC economists fall into the neo-Keynesian category, with a tilt toward neoliberalism. For simplicity, however, and because Ffrench-Davis describes himself as an updated neoliberalist, in this essay I have categorized both neo-Keynesians and neoliberalists under the neoliberalist label.

ized credit agencies “to do what the market has been unable to do spontaneously”: to make credit available at market rates of interest to small and medium-sized firms and for development of human capital (p. 33). The one country to follow this recipe for growth during the 1990s was Chile, and Ffrench-Davis considers it not coincidental that Chile is the one Latin American country to experience sustained growth throughout most of this period.

Ffrench-Davis’s policy recommendations in *Reforming the Reforms* clearly reflect the “neoliberalist vision” of the economy. Fully cognizant of the ever-present risk of rent-seeking and other sorts of government failures once the state enters the economic realm, he strongly recommends that state action be limited. Yet he insists equally that policy makers should overcome their classically inspired fear of using the state to help markets operate more efficiently. The key to efficiency and growth is not a shackling of the state but a limited and pragmatic use of the state. As Ffrench-Davis has argued elsewhere, “There is no instrument, or set of instruments, that can operate with complete efficiency; in an imperfect world, they must be judged by their overall results. Pragmatic use must be made of the policy instruments that offer the greatest net benefits in terms of macroeconomic stability and growth while minimizing costs.”²

Although the contents of *Reforming the Reforms* become rather repetitive in the later essays, Ffrench-Davis constructs a well-reasoned proposal for minimizing both government failures and market failures in Latin America: “It is not a matter of accepting or rejecting the market. . . . the relevant question is how much space [the market] is granted and what are the institutions and complimentary mechanisms that go with it” (p. 18). At points, he even echoes the advice of the World Bank by arguing that state intervention in the economy should be limited to areas where it is capable of acting efficiently and where policy will have the greatest impact.³

Ffrench-Davis’s neoliberalist arguments are reinforced by the contents of *Growth, Employment, and Equity: The Impact of Economic Reforms in Latin America and the Caribbean*. Barbara Stallings and Wilson Peres present the findings of a three-year, ECLAC-financed study of the impact of economic reform in a cross-section of Latin American and Caribbean countries that is representative in size, level of development, and geographic location. The main conclusion of the study echoes Ffrench-Davis: “The reforms had favorable effects in several areas, but they were not sufficient to foster dynamic, stable economic growth in the region” (p. ix). The great

2. Robert Devlin, Ricardo Ffrench-Davis, and Stephany Griffith-Jones, “Surges in Capital Flows and Development: An Overview of Policy Issues,” in *Coping with Capital Surges: The Return of Finance to Latin America*, edited by Ricardo Ffrench-Davis and Stephany Griffith-Jones (Boulder, Colo.: Lynne Rienner, 1995), 257.

3. World Bank, *World Development Report, 1997: The State in a Changing World* (Washington, D.C.: World Bank, 1997).

value of this study, however, lies in the authors' conscious effort to go beyond mere macroeconomic aggregates to embed reforms in the national and international contexts in which they were implemented. The results constitute an invaluable reminder of how the reforms interacted with other variables to produce policy outcomes.

Growth, Employment, and Equity also considers the impact of reform at the microeconomic level rather than merely reviewing once again the aggregate macroeconomic numbers. By looking at the response of sectors and firms to reform, the authors are able to understand the conflicting visions of the impact of economic reform in Latin America and the Caribbean: that it has been a source of economic modernization and dynamism versus the view stressing its role in undermining production and eliminating jobs. Behind the lackluster aggregate numbers lies a more complex reality created by the capacity of firms to react to a rapidly changing business climate. Some sectors and firms did extremely well in the wake of reform while others languished. The winners included large capital-intensive operations in manufacturing, agriculture, and services and the in-bond industry (*maquiladoras*). Losers were found in micro, small, and medium-sized enterprises intensive in labor in every sector of the economy (in manufacturing, the leather and textiles industries were hurt most). Growth therefore did not create enough jobs because, quite surprisingly, Latin America found its comparative advantage to be in capital-intensive industries rather than in labor-intensive sectors, as had been presumed prior to reform (with the important exception of the *maquiladoras*). Wages and income distribution eroded due to the resulting polarization in efficiency and economic success between capital-intensive and labor-intensive production, and thus between skilled and unskilled workers. Incomplete capital markets furthered this process by constraining the ability of small and medium-sized firms to modernize their production. Without this adjustment to the new economic climate, larger firms facing international competitive pressures were compelled to replace inefficient domestic firms in their production chains with imports. Expanding export production thus did not have a significant spillover effect that could have been a source of growth and employment in other sectors of the Latin American and Caribbean economies.

The neostructuralist argument championed by ECLAC seems to be exerting growing influence on economic policy making in the region. After the repeated failures of orthodoxy to solve Argentina's economic problems, the return of Domingo Cavallo to the economy ministry in March of 2001 was accompanied by a more heterodox approach to promoting growth and increased competitiveness in the Argentine economy. In Mexico the first post-PRI government of Vicente Fox is actively implementing many ECLAC recommendations, including credit agencies designed to direct credit toward small and medium-sized firms. And the Concertación government in Chile continues to implement an ECLAC-informed economic strategy. The

arguments put forth by Ffrench-Davis and by Stallings and Peres also inform much of the analysis contained in the remaining five books under review here, offering readers an opportunity to take a closer look at the viability of this seemingly logical counsel in Latin America's struggle for sustained growth.

Privatization and Economic Inefficiency

While Ffrench-Davis devotes his attention to trade liberalization and the opening of financial markets, the volume edited by Melissa Birch and Jerry Haar and those written by Luigi Manzetti and Judith Clifton focus on the third central component in the reform trilogy, privatization. For Latin American countries, privatization promised three core advances that should have promoted stable, healthy growth in the region. First, it would help stabilize the macroeconomic environment by reducing fiscal deficits. This goal would be achieved by eliminating the need to finance money-losing state-owned enterprises, by reducing government debt and hence its interest and amortization payments, and by signaling to international markets the seriousness with which the country was undertaking economic reform and thereby providing renewed access to international capital markets. Second, privatization would also free up state resources for investment in long neglected yet essential areas such as education, sanitation and health, poverty reduction, and infrastructure. Third, privatization promised to increase the efficiency of state-owned firms by replacing politically based decision making with the discipline of the market.

But did privatization deliver these benefits? Or did privatization fail to fulfill its promises and thereby contribute to the poor growth performance of the region during the 1990s? And if it failed, what were the reasons? These are the questions addressed in the volume edited by Birch and Haar, a work conceived on the principle that understanding what went right and what went wrong is an essential first step toward fixing the problems that have hindered regional growth.

The Impact of Privatization in the Americas represents the first academic effort to evaluate the effectiveness of privatization to provide macroeconomic stability, build the capacity of the state, expand the efficiency of state-owned enterprises, and increase employment, wages, and productivity. Although couched in the caveat that it is still too soon to reach a definitive judgment about the success or failure of privatization in Latin America, the case studies from Latin America and the Caribbean included in the volume lead the editors to some striking conclusions.

According to Birch and Haar, privatization in Latin America had a powerful positive effect on macroeconomic stability despite doing little to improve the fiscal balance of regional governments. It accomplished this task by sending a clear message to international markets that Latin America

was serious about economic reform. The resulting increase in market confidence in Latin America produced the return of flight capital and the inflow of new money into the region (pp. 217–22).

The impact of privatization on the efficiency of the formerly state-owned firms, by contrast, was less than laudatory in most instances, particularly when privatization was driven by an effort to reduce the fiscal deficit. Governments failed to recognize the cardinal principle of the market: efficiency comes from competition. To increase the price of the sale, governments often simply transferred public monopolies to private hands and either did not regulate the new firm or provided a very favorable (non-competitive) regulatory environment. And to increase the speed of the sale, governments often did not review sufficiently the ability of the new owners to run the firm. As a consequence, although the efficiency of the firms and the quality of services provided generally increased (in large measure due to service and investment requirements included in the privatization contract), privatization did not produce the competitive environment that would enable the market to generate improved living conditions for the majority (pp. 222–26).

Regarding the impact of privatization on employment, wages, and poverty, Birch and Haar conclude that it is difficult to draw any conclusions from the information contained in the country studies. Yet they agree that privatization seems to have increased the concentration of asset ownership in Latin America and that this trend tends to have a negative effect on incomes. Finally, although privatization reduced the fiscal responsibilities of the state dramatically, it ultimately did little to constrain fiscal deficits. And there is no clear evidence to suggest that privatization translated into increased efficiency in meeting human capital needs and reducing poverty (pp. 226–29).

The conclusions reached in *The Impact of Privatization* thus reinforce the neostructuralist view of reform in Latin America. Privatization produced renewed access to international capital markets and improved efficiency in firms, but these gains were far from sufficient to encourage sustained growth. To the contrary, privatization has fallen short of expectations in most Latin American countries because of lack of attention to building competitive markets. As Miguel Ramírez argues in his contribution on Mexico, “the determining factor for productive and allocative efficiency is the kind of market structure in which privatized firms operate” (p. 67). Where governments took this market reality into account, as in Chile and a few instances in other countries once the fiscal deficit ceased to be an overriding concern, success was greater. Where they did not, privatization did not produce a long-term impulse toward growth and development.

The implication of Birch and Haar’s *The Impact of Privatization* is that the demands of macroeconomic stability blinded policy makers to the importance of promoting competitiveness in the privatization process. Al-

though analysts of privatization in Latin America have long believed that to be the case, it is useful to have at hand a collection of essays that clearly reveal this dynamic. For a political economist, however, this conclusion seems to leave out a key element of the story: politics. The privatization studies by Luigi Manzetti and Judith Clifton help to overcome this limitation in the Birch and Haar volume by focusing their attention directly on the role of politics in the privatization process.

The explicit objective of Manzetti's *Privatization South American Style* is to illuminate why privatization produced significant economic inefficiencies in three South American countries. He argues that although economic factors mattered, it was politics that ultimately determined both the decision to privatize and the manner in which it was implemented. According to Manzetti, "as long as a president is skeptical about [privatization], it hardly gets off the ground, and even when it does, political factors . . . are likely to undermine its implementation" (p. 296).

Manzetti builds his argument on a simple yet useful model for understanding the interrelation between political and economic forces in the privatization process. He asserts that the decision to privatize is driven by a willingness to undertake such a radical policy change and an opportunity to do so. Both are defined largely by political factors. Although willingness can be defined by ideological considerations, Manzetti finds that it is largely a pragmatic variable driven by a politician's need to ensure political survival. In Argentina, Brazil, and Peru during the 1980s, therefore, significant economic incentives to initiate privatization were nullified by concerns about the political costs of such a move. Only once the economic situation had deteriorated into a crisis so severe that it dissolved domestic opposition to privatization in the 1990s were politicians willing to move forward. And although the opportunity to privatize depended greatly on the availability of willing investors, it would have been impossible without the favorable political mood created by economic crisis. Before embarking on privatization, politicians had to be convinced that it would "yield greater political and economic advantages than the 'politics as usual'" (p. 296). Regarding implementation, Manzetti agrees with much of the literature on economic reform in arguing that effective implementation was encouraged by a cohesive government team and limited technical problems. Yet he insists that ensuring support for the program among key societal and legislative constituencies was equally if not more important.

Inefficiencies in the privatization process thus resulted from political as well as economic factors. Reinforcing the current shared wisdom about privatization in Latin America, Manzetti shows that inefficiencies were produced first by the need for speed and high prices to hasten macroeconomic stability and the need to overcome investor hesitance to invest in unstable macroeconomic settings by selling natural monopolies with lax regulation. But political forces are shown to have had an equal hand in the

shortcomings of privatization. Speed in attaining macroeconomic stability was essential to maintain broad popular support for privatization and for the president. Equally, the collusion and corruption evident in Argentine and Peruvian privatizations and the large fiscal payoffs associated with privatizations in Brazil were designed to solidify private-sector and legislative support for the president and thereby ensure his political survival.

As a complement to *Privatization South American Style*, Judith Clifton's in-depth analysis of privatization in the Mexican telecommunications sector offers a clearer understanding of precisely how political need can produce economic inefficiency. Although the announced focus of *The Politics of Telecommunications in Mexico: Privatization and State-Labor Relations, 1982–1995* is the impact of privatization on democratic processes in the Mexican telephone workers' union, Clifton's analysis sheds light on the political-economic logic driving the privatization of telecommunications in Mexico. She also examines why it resulted in a guaranteed monopoly for the newly privatized Telmex, an extremely firm-friendly regulatory environment, and a consequent lack of competitiveness in the telecommunications sector in Mexico.

Clifton argues that economic necessity determined the decision to privatize Telmex: the need to modernize Mexico's telecommunications network combined with a bankrupt state incapable of carrying out this task. The way in which this privatization was implemented, however, was driven by the government's political aims: the need to reinforce the government's coalition with both business and labor. The administration of Carlos Salinas de Gortari thus designed the privatization of Telmex with the objective of winning allies in the private sector and establishing a new relationship with labor, one of the historic pillars of the ruling party whose alliance with the state had been severely strained by economic reform.

The challenge was to develop a privatization strategy that could mitigate the clear conflicts of interest between the union and the likely new owners of the firm. The union insisted that the technological modernization of the firm include retraining of the current workforce rather than mandating layoffs. The cost of such a strategy, however, could easily have scared off investors. The solution of the Salinas administration to this dilemma was ingenious, but it hardly enhanced competition. Labor's demand would be met, and the union would also receive 4 percent of Telmex stock along with other special privileges. To ensure investor interest under such conditions, the firm would be sold whole, rather than broken up into smaller competing enterprises, sold at a low price, and provided with a regulatory environment that would guarantee profitability for many years to come. To ensure that the sale would produce political payoffs in the Mexican private sector, Telmex was sold under conditions ensuring that the Mexican participants in the sale would control the firm with a purchase of only 10.4 percent of the company's stock. To maximize its revenue from an undervalued sale, the government retained 26 percent of the stock in the com-

pany, which it sold eighteen months after the privatization at a 400 percent profit.

The political forces shaping the sale of the phone company were not unique in Mexico. The government also managed the privatization of the banks, cement factories, toll roads, and numerous other firms to maximize political gain rather than economic efficiency. It even managed to conduct negotiations of free trade with the United States with an eye to winning support in the private sector. Clifton observes, "Political decisions played an immensely important role throughout the implementation of the privatization programme in Mexico, and this has been largely underestimated in the literature" (p. 5).

The studies by Clifton and Manzetti thereby raise doubts about the wisdom of the "neostriuctural conclusion" that market failures are largely to blame for the underperformance of the Latin American economies in the wake of economic reform and also about their counsel to make limited use of the state to increase the efficiency of market operations. These two studies instead reinforce the view of neoclassical economists that the logic of political survival will inevitably produce market inefficiencies, the principal source of disappointing growth in the region. When combined with the findings of the Birch and Haar volume, the conclusion seems clear. Both the neostructural and the neoclassical schools of economics highlight important obstacles to the effectiveness of economic reform in Latin America and the Caribbean. The evidence suggests that government failures interacted with market failures during privatization to undermine competition and hence to limit efficiency and sustained growth.

Given the presence of political and economic obstacles to effective privatization, how can the efficiency of privatization and the broader reform process be increased? Birch and Haar argue that the first-best solution involves four steps: to couple privatization with free trade to create competition even in the presence of a highly concentrated domestic ownership structure; to put an effective regulatory framework in place prior to privatization; where possible, to break up public monopolies before selling them to private actors; and to ensure transparency in the privatization process. If these four requisites are lacking (as was the case in most of Latin America on the last three items), the second-best solution is to attempt to implement an effective regulatory regime after the fact. As Birch and Haar admonish readers in the conclusion to *The Impact of Privatization in the Americas*, "privatization does not create competition or provide the outcomes that result when a competitive market operates." Given the presence of natural monopolies and highly concentrated domestic industries in Latin America, regulation is required, albeit limited and transparent regulation that "lets managers manage" (p. 230). But what kinds of policies and regulations are best suited to building competition in Latin America? And how might Latin America overcome the inevitable political hurdles inherent in pursuing this

second-best option: firms unwilling to relinquish the favorable conditions under which they made their purchase, and politicians who do not always place economic inefficiency at the top of their policy agenda? The books edited by Luigi Manzetti and by Moisés Naím and Joseph Tulchin attempt to address these questions.

Regulation and Competition Policy: The Means to Sustained Growth?

Manzetti's edited volume, *Regulatory Policy in Latin America: Post-Privatization Realities*, begins with the implicit belief that the conclusions advanced in the Birch and Haar volume are not sufficient. In the introduction, Manzetti insists that it is not enough to know that "privatization per se is only the beginning, not the end, of an economic reform that truly aims at creating competition in the marketplace" and that Latin America therefore must implement an effective regulatory regime (p. 4). The reason is that regulatory agencies in Latin America traditionally have not promoted competition. To the contrary, they have generally been captured by the industry they are supposed to regulate, implemented policies dictated by the political needs of the executive branch, or simply lacked the resources to do their job. The real challenge therefore lies in determining how to develop regulatory agencies with the capacity to promote a competitive environment: institutions independent from government and industry pressures, staffed by well-trained and well-paid employees, and flexible enough to deal with changing technology and market conditions (p. 5).

Regulatory Policy in Latin America purports to identify some of the "dos and don'ts" of regulatory reform and to distinguish some of the more serious obstacles to success. Disappointingly for policy makers, the volume is much more effective at identifying the regulatory "don'ts" and the obstacles to effective regulation than in identifying the "dos" of regulatory reform.

The contributors to the volume note that Latin American governments, in their zeal to appear market-friendly, "have been willing to dismantle the old [regulatory structure] rather than building the new," despite the need for regulation to promote competitive markets in various sectors of the Latin American economies (p. 283). They also agree (as do Birch and Haar) that it is better to build regulatory frameworks prior to privatization and that any attempt to regulate after the fact will be very difficult indeed.

But just how an effective regulatory framework is to be constructed remains unclear. For example, the contributors to *Regulatory Policy in Latin America* contradict one another on this key issue. Although one finds general agreement that the best way to regulate is to encourage market competition wherever possible, the contribution by Peter Schuck argues that "a priori, there is no reason to believe that market failures are greater and more harmful than government failures or vice-versa." Hence, "there is no reason a priori to favor markets over regulation or vice versa. Only after specify-

ing a society's values and history can we begin to construct a justification for one kind of political economy rather than another" (p. 26). Schuck then analyzes the nature of regulation in the United States and the forces that made it effective—a pro-market bias, implementation by a decentralized state, and a judiciary capable of enforcing regulatory laws—in order to draw some lessons for Latin America. An ensuing essay by Roberto Pablo Saba attempts to apply these findings in the Argentine case and reaches some sobering conclusions. Argentina, like much of the rest of Latin America, lacks a pro-market bias in societal and government attitudes, its politics tend to be highly centralized, and its judiciary lacks independence. Under these conditions, implementation of the U.S. model of regulation seems difficult at best.

Contradictions are also evident in the contributions on the banking sector in *Regulatory Policy in Latin America*. The essay by George Kaufman concludes that the best regulatory structure would be based on two factors: requiring banks to purchase risk insurance from private providers whose premium would be based on the degree of risk exposure of the bank; and early government intervention in troubled banks tailored to the particular characteristics of the banking system and the society, economy, and politics of the country in question. The problem with this proposal is evidenced in a later essay by William Gruben. The Kaufman proposal requires an effective measure of risk, and history has shown that financial risk is incredibly difficult to measure. As Gruben argues, there is "increasing evidence to suggest that many indicators typically used by regulators to assess bank health and to identify bank problems have been shown to be misleading." This is true in industrial countries, and even more so in developing countries. Hence, "banking crises in Latin America can surprise regulators rather than be anticipated and, therefore, planned for" (p. 244).

Naím and Tulchin's *Competition Policy, Deregulation, and Modernization in Latin America* is only somewhat more reassuring. They also argue that competitive markets are essential to long-term growth in Latin America. Tulchin goes further and insists that without them, "the sacrifices of restructuring will be wasted" (p. 267). Naím and Tulchin therefore determined to edit a volume dedicated to illuminating the best means of promoting competition in Latin America. Their aim is to understand better what is good competition policy, what has been done, what still needs to be done in Latin America, and how to promote competition in Latin America. The main conclusion of the contributors seems to be that the task is essential but extremely difficult.

The undertaking will be arduous for at least three reasons. First, the contributions on the history of competition policy in the United States and the European Union demonstrate that competition policy takes years to develop. Much time is required to build institutions—to win legislative support for autonomous and well-funded competition agencies, to train staff,

to change entrenched behavioral patterns in established agencies, and then to modernize the judiciary and build public support. The case studies of Venezuela and Mexico suggest why building public support may be a tough assignment in Latin America. Simply put, competition policy runs counter to decades of accepted behaviors instilled in an environment characterized by protectionism, collusion between government and business, collusion among competitors, the intentional creation and protection of monopolies, and the active use of price controls. These established modes of behavior are anti-competitive but cannot be erased quickly. Business will continue to use its organizational power to rent-seek, albeit in new and innovative ways, in the post-import-substitution reality. And society will tend to see the price increases enabled by competition and hence competition itself in a negative light. For this reason, Ana Julia Jatar argues in her contribution on Venezuela that competition policy will fail if it does not actively include an effort to change existing attitudes and behaviors.

A second difficulty with enforcing a competition policy based on an anti-trust approach (limiting the extent of economic power) is the obstacles it can erect to foreign direct investment, an important source of competition in Latin American economies. In markets characterized by high inherent investment risk, anti-trust actions could easily scare away potential investors. Also, in economies lacking effective legal protections for contracts, mergers and acquisitions become more desirable means of ensuring respect for contract provisions. Without the ability to merge with or purchase domestic firms, international investors may not enter some Latin American markets. But permitting this kind of behavior will lead to the formation of larger-scale enterprises.

Also obstructing the effectiveness of anti-trust efforts in Latin America is the need for increasing economies of scale in small domestic markets to compete effectively in international markets. It is clear that bigness and market power tend to undermine economic efficiency and that domestic competition is key to developing internationally competitive firms. Yet economies of scale matter as well.

These obstacles lead the contributors to *Competition Policy* to conclude that competition policy in Latin America must look beyond anti-trust, at least in the near term. An effective competition policy needs to focus on expanding free trade; unfettered entry for foreign investment; healthy and deep capital markets capable of providing financing to small and medium-sized firms; efficient and cost-effective infrastructure; a stable macroeconomic environment; autonomous, credible, and efficient judicial systems; and advocates for competition. Such a policy must also reduce corruption.

Can State Intervention Be Made Efficient?

Little doubt remains that a thoroughgoing reform of regulatory and competition policy is absolutely necessary if Latin America is to minimize market failures and reap the full benefits of economic reform. It is also clear that the technological hurdles are significant. Although the usefulness of the policy recommendations presented in the Manzetti and Naím and Tulchin collections is mixed, at least some counsel has been offered to policy makers for overcoming the technical challenges. Unfortunately, these volumes propose no means for overcoming the equally evident political obstacles to efficient markets. Yet without such a solution, how will it be possible to employ the state to minimize market failures, even in a limited capacity, without running the risk of significantly increased government failures? Only by strictly limiting the occurrence of government failures can the active, albeit limited, use of the state to correct market failures explicitly or implicitly proposed in the majority of the books reviewed here hope to increase market efficiency and growth in Latin America. Sustained growth in the region thus depends on significant political reform.

The content of the political reform that should accompany regulatory reform and the development of competition policy in Latin America is conceptually simple and far from new, yet its implementation will inevitably be complicated and time-consuming. The objective must be to extend the time horizons of politicians. When leaders cannot see beyond the end of their term in office, their economic policy decisions will inevitably be more concerned with near-term successes than with building the long-term health of the economy. Only when leaders have incentives to extend their policy focus beyond their term in office will they begin to consider the longer-term needs of economic efficiency and sustained growth.

Forests' worth of paper have been devoted to analyzing human societies and polities, how to improve their operation, and specifically how to minimize the time horizon problem. Yet inefficiencies persist everywhere on the globe, and particularly in Latin America and the Caribbean. Clearly, the political calculus in economic policy making is a powerful incentive with great capacity for mischief-making in terms of economic efficiency. Among political analysts, however, significant consensus exists regarding the utility of strong institutions to extend time horizons. Central among these political institutions are strong political parties and the system of checks and balances. Political parties have an interest in controlling the presidency into the future. As such, when parties are institutionally strong, they will have a significant capacity to encourage the president to consider the longer-term interests of the party in policy making rather than merely his near-term personal interest. Legislatures, judiciaries, and bureaucracies also have interests that extend across presidencies. When they are capable, autonomous, and well-financed, these bodies will have an important capacity to

limit the potential excesses of a president. These institutions can thereby help to limit policies that generate significant political benefits in the present but imply large economic costs in the future.

Building such institutions is far from simple but vital. Without such institutions, state intervention will tend to increase economic inefficiency rather than mitigate it. The books reviewed in this essay make it clear that market failures are one of the main factors limiting the effectiveness of market reform in Latin America. But the monographs by Manzetti and Clifton make equally clear the inevitable tendency for state intervention to undermine economic efficiency in the interest of political survival. Latin American states thus face a daunting dual challenge in their efforts to generate growth and well-being for their citizens.

Although most Latin Americans do not seem ready yet to “throw the economic reform baby out with the bath water of unfulfilled promises,” disillusionment and frustration are increasingly evident in the region. Even in Chile where the market model has registered significant success, the population is increasingly concerned about persistent economic inequality. Concerns about the weaknesses evidenced in the market model of development as implemented in Latin America in the last decade seem warranted. Yet carrying out the policies needed to minimize the shortcomings of the market model and unleash its potential benefits will be impossible if short time horizons continue to dictate the economic policy decisions of regional governments. To reap the real benefits of market reform, Latin American states must help markets operate more efficiently. Yet for virtually every country in the region, effective state intervention can only be assured following a thorough reform of their political institutions.