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Reforming the State

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Even though Latin American governments and their activities represent a far smaller percentage of GNP than those in more advanced economies, governments have a large role in the economy. In the past, government decisions have had a significant and sometimes deleterious effect on economic activity, creating instability and unpredictability, especially in the period before and during the external debt crisis of the early and mid-1980s. Subsequently, many governments embarked on economic reform programs. Today, after several years of very slow growth and in some cases, notably Argentina, outright economic depression, there is widespread frustration with the role of governments as reformers.

Nonetheless, since *Toward Renewed Economic Growth in Latin America* was published by Balassa et al. in 1986, there have been three significant improvements and changes in the role of the state in the economies of Latin America. First and most important, the destabilizing element of public finances has been reined in; the very large public-sector deficits and their impact in stimulating domestic inflation have been brought under reasonable control (see chapter 4), although significant fiscal weaknesses remain in most countries. Second, as part of fiscal stabilization, but also to increase economic efficiency, the role of the government as provider of commercial goods and services has been drastically reduced through privatization. Third, most governments have made some effort to cut back their overregulation of economic activity, both domestically and in external trade and payments, although their efforts and results have been uneven.

Have these efforts been sufficient to create a more just society and to stimulate growth? The performance of the 1990s suggests not. In all three areas, with a wide variety of ranges among countries but with clear underlying trends, a retrospective review suggests an "incomplete" grade.

Making the State More Effective

After 20 years of limited or nonexistent economic growth in the majority of Latin American economies, a major political debate is beginning in the region on the role of the state. In rather oversimplified terms, there are two basic questions: Should the state shrink to do fewer things but do them more effectively? Or should it have a larger role, taking up the slack left by low levels of private (and public) investment during the recent recession?

Certainly, the record of the past 20 years or so suggests four basic conclusions. First, fiscal resources are severely limited in most countries, and governments have little room to maneuver, at least in the short run (see chapter 4). Second, despite some progress, especially in Brazil, Latin American countries are far behind in the crucial area of educational achievement, particularly in providing education and training to those from low-income groups (chapter 8). Third, despite the progress in a number of countries in getting the state out of commercial activities, a number of the remaining but basic governmental functions are either not provided or are provided deficiently, especially public security and a functioning and honest judicial system. Fourth, government attempts to reduce poverty have in general been ineffective, while the maldistribution of income and wealth, one of the most skewed in the world (with a few exceptions, e.g., Costa Rica and Uruguay), continues much as in the past and, if anything, has probably deteriorated somewhat during the past two decades (see chapter 3).

An essential ingredient for any of these reforms is efficient, open, and competent public administration. Without it, market reforms cannot work properly. Most Latin American countries, both large and small, still have a long way to go in creating modern institutions of public administration. Civil service entry in most cases is not yet organized on a competitive basis. Because political interference in administrative decisions is the norm rather than the exception, young talent is discouraged from entering public administration, with the exception of a few semi-independent agencies such as central banks and in some cases finance ministries and the diplomatic service. Crucial sectors—such as the administration of education, health care, and public infrastructure—suffer from political interference, lack of a career path for civil servants, and pay that is substantially lower than in comparable private-sector positions. The result is sometimes a confrontational attitude toward the private sector—and sometimes corruption and ineptitude.

Although European countries today are backtracking from the elitist and competitive civil services that flourished (especially in France and the United Kingdom) in the postwar period, a dose of both elements might be productive today in Latin America, introducing more order and competence in public administration. By creating a kind of elite "officer corps" in the civil service, Latin American countries would not only raise the professional level of the civil service—as Spain has done in the past 50 years—but by raising the social and economic status of senior civil servants, governments would also in time sharply curtail the temptations for corruption.

Another essential element is to define more clearly than in the past the scope and range of government regulation of the economy. This goes from tariffs and trade to the exchange system and labor markets. Substantial progress has been made in virtually all countries in deregulating prices; not coincidentally, inflation has fallen sharply in most countries. However, most countries lag in having a transparent and effective system of bankruptcy proceedings, thereby introducing unnecessary rigidities into the economic system, especially during times of recession, as now.

A crucial area of economic regulation is that of public utilities. With the privatization of basic utilities, particularly telephones and electricity, regulatory reform has assumed increasing importance. Although most countries have created ostensibly independent regulatory agencies, many are still having growing pains in setting up a regulatory process that is fair, predictable, and transparent. Tariff changes are sometimes sudden and politically motivated, as happened with Chilean telephone tariffs in 1997; the public is given little information on the reasoning behind regulatory decisions and therefore has no stake in the system. Moreover, regulators sometimes have hidden motives, such as trying to assuage authorities by appearing to be tough; at other times, they are too close to the companies they are supposed to regulate.

Some of these problems also occur in more advanced economies and are complex to tackle. Besides better professional preparation and the time it takes to develop objective regulatory systems, perhaps the most important missing ingredient that needs to be developed is public education on regulatory issues.

Deregulation, or rather sensible regulation, is but one element necessary for economic growth. Nonetheless, it is an important element for investors, both domestic and international. The periods of intense progress in deregulation, such as in 1991-93 in Argentina and Peru, were accompanied by a substantial inflow of direct and portfolio investment from abroad—including the reflow of flight capital—as well as the start of industrial restructuring and of domestic investment. It is not a coincidence that deregulation, capital inflows, and privatization all went together, each one influencing the other, making the other possible, and reinforcing one another.

Privatization

Privatization came about in most Latin American countries in the 1990s from a mixture of two main motives. The overriding one was the financial crisis in the public sector (e.g., Salinas 2000, chap. 14), where the losses of state-owned enterprises and the subsidies they received from the central government accounted for as much as half of the public-sector deficits of the largest countries and for most of the deterioration of public finances from the mid-1970s to the early and mid-1980s (Larraín and Selowsky 1991, chapter 8). The other motive was the appalling decline of public services in the 1980s, especially in electric power and telephones, after most of the utilities had been taken over by governments in the 1960s and 1970s.

The combination of financial crises and high inflation (hyperinflation in Argentina and Peru) and the utter failure of essential public services in a number of countries provided a propitious setting for governments to push privatization through reluctant legislatures. A third motive, particularly important in Chile, the precursor and pioneer in privatization, was the strong ideological conviction among the economic advisers to the government that privatization was essential to raise the low level of efficiency of the economy.

There is no doubt, more than 10 years after the start of privatization in 1990 in Mexico and Argentina (emulating the earlier example of Chile, and followed later by Peru, Brazil, and most of the countries of the region), that the provision of basic public services—particularly electricity and telephones—has vastly improved in comparison with the erratic and expensive delivery of the 1970s and 1980s. The power interruptions (*apagones*) so typical of the late 1980s in Argentina, Colombia, and Peru, among other countries, probably lopped 1 percent off their GDP annually in those years (OLADE 1993). The very large improvements in the efficiency of privatized electric distribution systems in the 1990s—eliminating clandestine connections, reducing distribution losses by replacing obsolete networks, and stimulating competition among generators—not only eliminated the huge costs to industry arising from power outages but also made possible a reduction in prices for users, as is noted below.

The record in other activities is less clear-cut. In telephone systems, the lengthy monopoly positions granted the carriers in Argentina, Mexico, Peru, and Venezuela at the time of privatization—to improve the price for the selling governments and to give time to the buyers to make the large investments required as a condition for privatization—enabled the privatized monopolies to maintain high prices, especially for long-distance service, and to exclude potential competitors until the monopolies expired in the late 1990s. Nonetheless, because of investment and performance commitments made at the time of privatization, service improved dramatically over the pitifully low standards of the 1970s and 1980s.

Privatization in other sectors was stimulated by the selling governments' absorbing a major part of existing debt. In steel, the strategy by and large was successful, especially in Argentina and Brazil. In airlines, however, in line with the difficulties of commercial aviation worldwide, privatization simply shifted the burden of maintaining national carriers of dubious potential from the public sector to the commercial banks, some of which were at that point still state owned. The privatized Mexican airlines in effect went bankrupt—along with a smaller private-sector competitor; the Peruvian and Venezuelan carriers also went bankrupt and were closed in the late 1990s, while Aerolíneas Argentinas, privatized in 1990, struggles on to avoid formal bankruptcy. Seen from another perspective, the gradual disappearance of these airlines was hastened by privatization, a positive and in the end unavoidable development in an industry with worldwide overcapacity.[1]

The major contribution of privatization in its various forms (outright sales, concession agreements, and management agreements) has been in public utilities, where the two or three decades in the 1960s, 1970s, and 1980s of state ownership in Latin America resulted in erratic prices, underinvestment, wastage, and large-scale foreign borrowing, and in various countries (though not all) in poor coverage. Privatization corrected these flaws, substantially increasing coverage. The areas that needed this increased coverage were the poor ones, where governments had already in the 1970s and 1980s made a significant effort. As a result of the investment programs mandated under privatization, privatized electricity companies were able in the 1990s to extend coverage to virtually 100 percent in their concession areas. Blackouts were eliminated, and shut-offs for maintenance were sharply curtailed (table 2.1).

It is true that to prepare electric utilities for privatization, electricity tariffs had to be sharply raised; the state-owned companies were not viable without these increases. But simply raising tariffs without changing ownership and management would not have been enough; many old habits died hard, particularly that of stealing electricity, not only a very dangerous activity but also one that raised costs for those who did pay. Before privatization, most state-owned companies had nontechnical losses (i.e., stealing) of about 12 to 15 percent. This percentage has today been reduced in most cases to 1 to 3 percent, with corresponding benefits in coverage and cost to the customer.

Much has been made by some politicians of supposedly high electricity tariffs. First, in reality, because of the mandatory productivity improvements included in tariff formulas in most countries, tariffs have gone down in dollar terms. In Chile, they have fallen by about 15 percent since privatization, and by much more in Argentina (table 2.1). Second, a

1. Ramamurti (1996); see chapters 6, 7, 8, and 9. Also see Grosse (1996) on Aerolíneas Argentinas (in the Ramamurti volume).

Table 2.1 Coverage, average tariff, and efficiency of privatized electric systems in selected Latin American countries (at the time of privatization compared with the latest year, 2001 or 2002)

	Coverage (percent)		Average tariff (cents per kilowatt-hour)		Losses from distribution system (percent)		Hours of interruption per month	
Country	**At privatization**	**Latest year**	**At privatization**	**Latest year**	**At privatization**	**Latest year**	**At privatization**	**Latest year**
Chile	90	98	10.0	8.6	14	5	—	—
Peru (Lima area)	75	100	9.2	9.0	20	9	72	1
Peru (national)	48	75	—	—	21	9	—	—
Argentina	94	95	3.8	2.9	22	10	17	5
Brazil	90	94	7.7	9.0	9	8	26	15

— = not available

Sources: Utility companies and regulatory bodies, plus ECLAS, CCPE (Brazil), U. Católica (Chile).

Table 2.2 Basic statistics of privatized telephone systems in selected Latin American countries (at the time of privatization compared with the latest year, 2001 or 2002)

Country	Statistic	At privatization	Latest year	Percent coverage in latest year (total number of phones ÷ population)
Argentina	Fixed lines (thousands)	1,700	8,400	41
	Mobile phones (thousands)	12	7,200	
	Average tariff (cents per minute for local call)	3.1	0.9	
Brazil[a]	Fixed lines (thousands)	22,000	48,000	48
	Mobile phones (thousands)	7,000	29,000	
	Average tariff (cents per minute for local call)	0.8	0.3	
Chile	Fixed lines (thousands)	600	3,500	59
	Mobile phones (thousands)	—	5,500	
	Average tariff (cents per minute for local call)	3.2	1.8	

— = not available

a. Privatization occurred in 1998.

Sources: Telephone companies and regulatory bodies for the respective countries.

number of governments have introduced cross-subsidies for really poor consumers, namely, those using in the range of 100 to 200 kilowatt-hours a month. Where this has been done, complaints about the cost of electricity have all but disappeared.

The story of telephone systems has been more complicated, but in the end a wide swath of the population has benefited from the spread of cellular or mobile telephones, an area of intense competition (table 2.2). To maximize fiscal revenue at the time of privatization, governments that privatized telephone monopolies (Mexico, Argentina, Peru, and Venezuela—in that order—and earlier Chile) offered a guaranteed fixed telephone monopoly for a period of years, usually 5 to 7, which was extended in some cases (Argentina and Mexico).

The acquiring companies, having seen 20 years of nationalizations and defaults, were also hesitant to participate without a guarantee period. Much of this was inevitable, given the difficulties of attracting investment at the time, but a fair criticism can certainly be made about the time it took to bring long-distance rates down from the extremely high levels prevailing in most countries other than Chile—which already had among the lowest and most competitive long-distance rates in the world, as befits an export-oriented economy. It is in mobile telephones that the fastest gains in coverage in urban areas were achieved, once they were opened to competition; intense price competition and special economy rates have extended mobile telephone use to people with modest incomes.

A review of the status of privatization in Latin American economies suggests that very significant progress has been made in a number of countries, but that progress has been uneven, both by sector and by country. Some countries have not embraced privatization because of strong historical resistance by an aging population (this has been the case in Uruguay) or because of political instability (e.g., Ecuador). Others, such as Colombia, have not been able to get very far because of investor resistance; the state-owned parts of the Venezuelan aluminum industry are another example.

The privatization pioneer, Chile, basically stopped significant privatizations after 1989, with the exception of the main rail line; water systems and the copper-mining industry remain partially in state hands. Large state-owned commercial banks continue to exist in a number of countries, such as Banco do Brasil, Banco de la Nación and Banco de la Provincia de Buenos Aires in Argentina, and Banco del Estado in Chile. After much discussion, the state of São Paulo sold off its state bank, Banespa, to BSCH of Spain in an international bid in 2000. The energy area in Mexico remains largely untouched, except for a few private electricity-generating plants—whether state-owned or privately owned, a generating plant will have similar performance, so that the efficiency benefits of competitive private management are smaller for generation than for distribution.

Did privatization contribute to economic growth? In a general way, there is no doubt that privatization was one of the key elements that helped to jump-start economic revival in the countries that were the most aggressive privatizers (Chile, Argentina, and Peru). But in other countries that did less in privatization (Brazil, Mexico, and Venezuela), the effects were also less clear-cut. More systematic surveys (e.g., by Lora and Panizza 2002) that group the effects of all the various reforms together show major gains in productivity and income in Argentina and Peru in the 1990s, as well as in a number of smaller countries (and of course in Chile in the 1980s). As for the distributional effects, on which there has been much political commentary but little analysis, it is clear that the privatizations in Latin America, which focused principally on carefully structured sales of utilities, avoided the excesses and concentration of wealth that came with the sales and privatizations of state-owned industrial and energy firms in Russia and Eastern Europe (Birdsall and Nellis 2002).

The unpopularity of privatization in recent years in most Latin American countries has come from a variety of sources. First, some presidents turned publicly against privatization when they saw that they had run out of big-ticket items to sell off (e.g., Alberto Fujimori in Peru and Carlos Menem in Argentina, both of whom were trying to get elected to unconstitutional third terms) and therefore that there was limited political mileage in pursuing privatization. Second, the memories of the very poor utility services of 10 years ago are fading in a number of countries. Third and most important, very little effort was made to create a wide shareholding for privatized companies. The exceptions were some of the telephone companies and the energy company YPF in Argentina, but in the end it was sold in its entirety to Repsol of Spain.

Privatization is a work in progress in Latin America. Because of worldwide overinvestment in telephone and electricity systems, major players in the United States and Europe—pressed by their regulators—are trying to exit from areas that are not central to their main business. That means selling Latin American assets, where growth peaked in the late 1990s and the Argentine crisis and the 2002 presidential election in Brazil have cast a pall in boardrooms. Many assets will be sold at knockdown prices in the next year or two. What that will do to concession agreements and to service is still very much an open question.

The Rule of Law—Personal Security

If there is one area where the government has a clear role it is that of controlling crime and providing physical security for its citizens. Yet, in the words of a recent report by the Inter-American Development Bank, "Crime and violence have become staple features in most Latin American countries. Despite the persistent lack of reliable data, what statistics are available indicate that the region has one of the highest crime rates in the world" (IDB 2000b, 71).

The economic cost of crime in Latin America is not quantified, but there is no doubt that it is very substantial. A country such as Colombia, admittedly at the top end of the insecurity spectrum, annually spends 6 percent of GDP on private security and criminal justice—not counting the direct costs of crimes committed, from assaults, in property damage (e.g., pipelines cut and oil spills), in ransom paid, in investment forgone, in emigration to cities and abroad, in large-scale psychological damage, and so on.

Crime and insecurity show no sign of abating. Estimated statistics show a dramatic increase in the 1980s in homicide rates, which have in most cases stayed at high levels since then, with variations by countries. There were reductions in Peru, for example, and increases in Argentina, Mexico, and Venezuela (table 2.3).

Other than unemployment, crime consistently ranks at the top of citizen concerns in most Latin American countries. No government can afford to be complacent about this problem. The difficulty with crime control in Latin America, as elsewhere, is what approach to take. As in the United States, the public and the police favor punishment—sentencing offenders and building more jails—whereas social scientists usually emphasize prevention—such as supervision of troublesome adolescents and incentives for children to complete school. In the United States in the early

Table 2.3 Homicide rates for selected Latin American and Caribbean countries, 1980-2000 (homicides per 100,000 inhabitants)

Country	Circa 1980	Circa 1990	Circa 2000	2000/1980
Argentina	3.9	4.8	8.2	2.1
Brazil	11.5	19.7	17.4	1.5
Chile	2.6	3.0	1.7	0.7
Colombia	20.5	89.5	65.0	3.2
Mexico	18.2	17.8	26.0	1.4
Peru	2.4	11.5	4.9	2.0
Trinidad and Tobago	2.1	12.6	—	—
United States	10.7	10.1	5.5	0.5
Venezuela	11.7	15.2	25.9	2.2

— = not available

Source: World Bank data, as shown in Instituto Apoyo, *Seguridad Ciudadana* (2001), based on local police and Ministry of Interior reports.

1990s, 94 percent of law enforcement budgets was aimed at crime control and punishment, and little at prevention; according to the Inter-American Development Bank (IDB 2000b, 74), this proportion is likely to be even more skewed in Latin America.

In this regard, much can be learned from Japan, a country with one of the lowest crime rates. There is a police presence at the local level, physically visible every few blocks in a Koban, a sort of miniprecinct where the public is invited in and can give the police good information on their particular area, thus building up the trust of citizens in the police. Although the setting is different, elements of this system—a combination of local pressure with "big brother" watchfulness—might work in some Latin American countries.

In much of Latin America, on the contrary, the police inspire little trust. In Argentina in the 1996-98 period, even before the recent crime wave that accompanied the recession, almost 80 percent of urban residents did not trust the police.[2] A similar percentage prevails in Peru (Ortíz de Zevallos and Pollarolo 2000, 198), and high levels of distrust occur in such other countries as Brazil, Mexico, and Venezuela. Insecurity is the major factor behind the recent part-time emigration of businesspeople from Colombia, Mexico, and Venezuela, among other countries, to places such as Miami. Needless to say, this is accompanied by a movement of savings abroad—in short, by capital flight.

Seventy-five percent of Latin Americans consider that there is no equality before the law. They believe that the police and the courts protect the powerful rather than the broad mass of the population. Even in a socially more developed country such as Uruguay, the percentage is still relatively

2. As stated in IDB (2000b, 76).

high at 49 percent. The first thing that is therefore required in the fight against insecurity and crime is to restore trust in the police and the judicial system. This will require training, time, and especially funds. Moreover, crime prevention is a broad subject that encompasses a large variety of subjects, ranging from aid to abandoned children—a major tragedy in large urban areas—to public works programs and supervision for students seeking to complete secondary school. (The last, incidentally, is a salient weakness of Latin American public education systems and is the main reason that Latin Americans average only 5 years of schooling compared with 7.5 years for Southeast Asians.)

An approach to security that emphasizes crime prevention involves more public spending. The difficulty is that legislatures and the voting public do not directly connect the additional savings to society from crime prevention, which takes time to show results, to the additional public expenditures, which are immediate. In any case, it is clear that public expenditures on police and related matters would have to rise above their present very low level of 1 to 2 percent of GDP in most countries—not counting additional expenditures on related priority social services, particularly education.

The Rule of Law—the Judiciary and Civil Society

Any effort to improve public security needs to include judicial reform. Many good recommendations have been made on the subject, and over the years a number of countries have made efforts to streamline judicial procedures, raise administrative efficiency, and make the judiciary independent and honest. But these efforts still have a very long way to go. The average Latin American judiciary is still very far from being independent from the government in power or from previous governments that appointed the judges; procedures focus on formality rather than substance (partly a result of the intellectual inheritance of Roman Law plus the Napoleonic Code, in contrast to the Anglo-Saxon tradition of common law), thus bypassing norms usually taken for granted in countries practicing common law, such as the presumption of innocence until proven guilty.

Judicial efficiency is still a distant objective, with huge backlogs of both civil and criminal cases. Inefficiency and bureaucratic slowness create large costs for society, in effect making recourse to justice an experience only the wealthy and influential can afford. If corruption is added to inefficiency, a state of affairs in a number of countries—notably Peru in the late 1990s—then the judiciary ceases to fulfill its role as a central pillar of civil society.

Among the recommendations frequently made to improve the judiciary is that of raising the salaries of judges. Comparisons are often made between the compensation of judges and those of the top lawyers that litigate before them; as in industrial countries, however, there is a large difference between the earnings of top lawyers and those of the vast majority of lawyers, most of whom are solo practitioners and are often only partially employed. Although it is important to improve the level and the predictability of judges' real earnings, it is just as important to establish a career path for them, with recognized standards of selection and promotion. Only in this way will the judicial profession over time gain the respect of society at large and have a better chance of avoiding corruption. Taking again the example of Peru, almost half of the 800 judges there are on temporary contract, with no clear career prospects; this failing is fertile ground for corruption (Instituto Apoyo 2000).

One area that holds promise for unclogging judicial systems and bringing them closer to the people is that of the justice of the peace (*juez de paz*), who sits at the local level. He or she can resolve the type of local disputes that tend to occur in rural areas—such as disagreements over water rights, cattle rustling, rights-of-way, and property boundaries—without clogging up the judicial system, which is usually represented by a court in a distant city. Some sort of central quality control is needed for such a system to work, so as to avoid the petty favoritism that tends to occur in small localities all over the world.

In a number of Latin American countries, the judiciary operates under very difficult circumstances. In Colombia today and in a number of Central American countries in the past, for example, judges have been threatened and even killed by both guerrillas and paramilitaries in civil wars. Gigantic cases of corruption—in Argentina, Brazil, and Peru, for example—have put enormous political pressure on judges to reach quick verdicts when the judicial system has very limited budgets to marshal and analyze evidence.

Another obstacle is the nature of legislation, which is often vague and leaves too much room for discretion; in the words of a well-known Mexican political and economic analyst: "Curiously, the Mexican legal system is analogous to that of the former communist regimes. Laws and regulations are written in discretionary terms. . . . This makes government action unpredictable, not only because ambiguous law is easy to manipulate."[3] The results of this ambiguity have also been evident elsewhere, perhaps most conspicuously in Argentina, where judicial decisions that are out of touch with economic reality have periodically upset macroeconomic policies.

The needed improvement in the judiciary is thus not a task that can be tackled in a vacuum, independent of other aspects of social and economic development. To ease the transition to a more open civil society, the essential ingredient of an independent judiciary must be accompanied by a

3. Luis Rubio, "A Rule of Law Emerges in Mexico, Slowly," *Wall Street Journal*, April 27, 2001.

free press and an active participation of nongovernmental organizations that can publicize the concerns of particular groups of citizens and over time can lead to informed debate about the issues facing government. This evolution will lead to a better informed, more independent judiciary; conversely, a more independent judiciary will lead to a better informed, more open government and society. The development of an effective judiciary is thus an interdependent part of social and economic development.

Decentralization

A key issue in the management of Latin American economies is decentralization. One of the legacies of the external debt crisis in Latin America during the 1980s, as well as of the return to democratically elected governments at about the same time, has been a desire to decentralize government from the center down to the local level.

This pressure for change comes after almost 500 years of unusually strict although often ineffective centralization. In the words of a leading student of the subject: "Spain's [and also, but to a lesser extent, Portugal's] legacy to Latin America was a tradition of extreme centralization in government decision making and an elitist social structure that impeded the implementation of central government policies. Local government was grossly neglected during the post-independence period" (Nickson 1995). This tendency continued right up through the 1970s and early 1980s, partly reinforced by international aid agencies, including the US Agency for International Development, that liked the simplicity of dealing with one decision maker per country—in sharp contrast to the federal principles of the US government (Nickson 1995, 16). An exception to this centralization has been the Inter-American Development Bank, which has traditionally supported local and municipal investments.

The centralizing trend was an accident of history. Spain had had a long tradition of autonomously run city-states, going back to Roman times. By the end of the 15th century, just before the conquest, the desire of the Crown to assert national control ran straight into local autonomy. The Comunero rebellion of 1521 and the confrontation between the Crown and the Santa Hermandad (Holy Brotherhood) of cities sealed the fate of local autonomy. In the colonies, conquistadors (known as *adelantados*, those who go ahead) were given special powers over the town councils (*cabildos*), and under Philip II municipal positions were sold to raise royal revenues. In Brazil, town councillors were restricted in the 17th century to *homens bons*, landed gentry untainted by commerce or labor.

In general, a long tradition was established of weak local government, with the bulk of local revenue channeled upward to the capital and from there to the Crown (Nickson 1995, 7-25). These arrangements, which have continued with some changes until today, have sparked periodic local rebellions and unrest, especially in such far-flung and diverse countries as Argentina, Brazil, Colombia, Mexico, and Peru, where impoverished local populations feel they are getting a bad bargain from a distant capital.

Today, decentralization is widely seen as a test of democracy, a necessary reversal of past authoritarian trends. However, the long tradition of centralization and authoritarianism dies hard, and change is not easy. Despite this difficulty, there is no doubt that the benefits of properly managed decentralization can be considerable for economic development: the ability to relate investments to local needs, a sense of local involvement that breeds greater interest in how public money is spent—especially if it is seen as coming from local taxation—and better knowledge of local conditions, which is especially important in the agricultural areas where low-income people usually are concentrated.

At the same time, the fiscal perils of excessively rapid decentralization, without formal arrangements for control of local expenditures and of revenue sharing, are well known and have been the subject of much comment and discussion (Fukasaku and Hausmann 1998; Giugale and Webb 2000). Rapid decentralization of revenues without proper control of expenditures was undoubtedly one of the major causes of Argentina's and Brazil's fiscal problems in the 1980s (see chapter 4).

Several issues need to be faced to achieve efficiently functioning decentralization. These include training of local officials; a clear framework that delineates responsibilities among the central government, states (or provinces), and municipalities; financially viable municipal units (many are too small to operate efficiently), or schemes to share revenues and functions among municipalities; and, given the large income disparities between large cities and rural areas, functioning schemes that equalize or reduce these disparities through transfers.

In the United States, state and local governments collect and keep sales taxes and property taxes as well as income taxes (in most states); these revenues are roughly equivalent to 10 percent of GDP (compared with 22 percent for federal revenues). In Latin American countries, by contrast, the autonomous sources of revenue for local governments are few and far between—other than transfers from the central government. The main sources of local revenue are fees and some payroll taxes; urban property taxation is relatively underdeveloped, and taxation of land is virtually nonexistent. In Mexico, for example, property taxes on average are only 13 percent of municipal revenues (Giugale and Webb 2000, 17), although the proportion is higher in some of the large cities. Whatever the composition of local revenues, without a strong local revenue base, decentralization cannot be a functioning reality.

The organization of the relationship between the center and the states and municipalities in Latin America spans a wide variety of systems. At one end is Brazil's federal system, in which states raise their own revenue (as well as receiving substantial federal transfers) and control their own expenditures—although the federal government intervenes, sometimes decisively (Giugale and Webb 2000, 3). From there on, a combination of federal and central systems prevail. Some countries have a large number of municipalities and others not many—for instance, Peru has roughly 1,900 (with only 14,000 inhabitants per municipality), whereas Uruguay has only 19 (each with an average population of almost 170,000 in 1994). Peru tried in the 1980s to bring cohesion to the dispersion and small size of local government by creating a few large regions, but these had difficulty in getting established because voters, especially outside the capital city of Lima, felt too remote from them.

Decentralization is an ongoing process that is not subject to relatively simple prescriptions. It is a more complex subject than others, such as fiscal balance, privatization, or opening up trade, where one-size-fits-all appears more or less to have worked in most countries in the region.

Nevertheless, even though different systems are likely to work in different countries, the devolution of more responsibility and economic power to provinces and localities is important so as to give voters and local governments a sense of participating in the development of their country. The problem is how federal governments can cap state and provincial deficits, so as to avoid the pressure for the center to periodically assume decentralized debts, thus undermining national fiscal stringency. Brazil, with its "internal IMF programs" and Law of Fiscal Responsibility, provides an encouraging model. If decentralization can be combined with fiscal responsibility in the coming decades—reversing the practice of several centuries—a stronger base will have been laid for development and democracy.

A Final Comment

For Latin American governments, the next several years will be a period of special challenge. After a period of restructuring the state—especially shedding commercial functions and deregulating the economy—the lack of growth in the recent past is leading to calls to augment government's role in the economy. If this larger role means more and better investments in high-priority areas—such as education, preventive health care, and rural infrastructure—then the call for change will have been worthwhile. But if it leads to the type of unfinanced fiscal expansions that took place in the 1970s, then it will be a setback for the region.