

## Las Nuevas Reglas del Juego (The New Rules of the Game)

### Index

1. Introduction: Political underdevelopment and essential reform in Latin America: the principal hypothesis

Stephan Schmidheiny - Hernando de Soto

2. Las Nuevas Reglas del Juego (The New Rules of the Game)

The mission of business within the framework of lasting economic development

Stephan Schmidheiny

### **1. Introduction. Political underdevelopment and essential reforms in Latin America: the principal hypothesis**

Stephan Schmidheiny - Hernando de Soto

This book seeks to make a contribution with respect to the causes of and possible solutions to economic and political underdevelopment in Latin America, addressing this important issue with openness, sincerity, and creativity.

Latin America is a continent that enjoys vast economic and human resources. There is absolutely no doubt about its enormous potential for driving business initiatives, generating jobs and better pay, as well as higher income for its population. Nevertheless, the development of most of its countries is nearly static and frequently discontinuous. The plunge from boom to bust is often rapid and abrupt, and instances of sustained, lasting development are rare.

What causes this phenomenon? Traditional explanations are obsolete. Compared to the rest of the world, Latin America has a better-than-average variety of raw materials. It is rich in land, water, and coastlines. Access to foreign markets, international technology, and foreign capital is no more difficult than in other regions of the world. And its young population is capable, talented, and ambitious. So, clearly, socio-cultural factors are also not a stumbling block to more dynamic development.

Why, then, that "lost decade" of the 1980s and the pessimistic predictions for the nineties? For many years, development theorists and politicians have been lavishing ever greater attention to causes of underdevelopment in Latin America which can hardly ever be influenced, such as natural resources, outside forces, culture, and history. Rarely have they looked at the successful example of the industrialized or developing countries, whose decisive advantage over the underdeveloped countries lies in the strength of their economic, political, and legal institutions. These democratic institutions, to which the majority have access, have made it possible to establish reliable rules of the game, which, in turn, have given all citizens the ability to compete under equal conditions. They have allowed sustainable, lasting economic development and have decreased the tensions generated by restricted access to economic opportunity, a bias which often leads to violence.

It is precisely the building of an institutional environment such as this, that the majority of Latin American countries have not been able to achieve to date. On the contrary, institutional insecurity and arbitrariness in political and economic decision-making create a climate of distrust, opportunism, lowered sights and objectives, favoritism, and corruption. We call such a system "mercantilist" because it allows just a small political and economic "elite" access to markets, making such access difficult or even impossible for the vast majority. This elite consists of the bureaucracy of the State and private bureaucracies. Its goal is to protect its own privileged interests and increase its own revenues. These institutions create a national economy and a political structure that can be neither efficient nor socially just. And they are the main reason why Latin America has been losing economic competitiveness and political relevance throughout the world for more than 20 years.

So, our central hypothesis is that the quality of a country's legal and political institutions determines the conditions of its environment and the rules of the game, which is the factor that is essential to sustained economic, social, and political development.

This hypothesis establishes the cornerstone for a new paradigm of sustained development in Latin America: most countries on this continent need broad, sweeping institutional reform that opens markets, simplifies bureaucratic red tape, guarantees the security of property, and simultaneously ensures participation of the people in governmental decision-making. Moreover, this reform should be carried out from the bottom up, based on reality and the needs of the large, impoverished majorities in the Latin American countries. This new paradigm would entail macroeconomic stability and adjustment of the economic structures, making them lasting and sustainable, because all have participated in establishing them, from the bottom up, instead of having been imposed from the top.

This will require basic institutional reforms. Specifically, this means listening to the people, including the vast majority of the population in the decision-making process. In order to accomplish this, effective measures for integration of the immense disadvantaged informal sector, which represents more than 50 percent of the Latin American population and generates 30 to 40 percent of the Gross Domestic Product, must be established. The strategic importance of this sector is reflected in the observation that, on their own initiative, its members have established a market economy open to all, with a high level of competence; they have implemented simple rules of the game that are respected by all, and have created democratic organizations to administer their settlements, syndicates, and unions. Since there are no adequate formal institutions, this sector manufactures its own imperfect, yet democratic, institutions. The fact that this sector is called "informal" says everything that needs to be said about the "formal" sector. For a while now, semantics have been overtaken by reality.

Only open dialogue and a consistent focus on the quality of the arguments with regard to the institutional reforms needed to achieve this new paradigm will enable Latin America to move forward. This book contains fundamental contributions on the solutions available to help Latin America rediscover the road to prosperity and wealth. They are the result of discussions held on November 5 and 6, 1990 in Santiago, Chile, in which approximately 200 public figures, statesmen, politicians, business leaders, union members, journalists, economists, and representatives of national and international institutions participated. The authors come from various Latin American and European countries and the United States of America. This diversity of backgrounds and experiences, ideologies and perspectives is essential to this discussion and, in fact, is reflected throughout the book.

The dialogue initiated at the Santiago Conference should, and surely will, continue. We are on the threshold of a process that can lead to the comprehensive, sweeping institutional reform which has been a frustrated dream in Latin America for so many years and which can, if the

winds are favorable, result in not just a major turnaround in the continent's development, but the true redemption of Latin America.

## 2. Las Nuevas Reglas del Juego (The New Rules of the Game)

The mission of business in the framework of lasting economic development

Stephan Schmidheiny

Like all the other social functions that fall within the framework of a country's development, the business leader's mission is subject to constant change. In the seventies and early eighties, the legitimacy and social benefits of business activity were widely questioned by those advocating collectivist tendencies. But more recently, social acceptance of the profession of business leader or entrepreneur has greatly increased worldwide.

Personally, I see two major reasons for this evolution: Firstly, the market economy system, which establishes the conditions of the environment in which the business leader or entrepreneur operates, imposes itself strongly on collectivist economic models. Secondly, in view of the protests to which they have been subject, entrepreneurs and businesses have developed substantially on their own the characteristics of their profession and their social mission.

I shall concern myself mainly with these two aspects of the profession of the business leader and entrepreneur - in the first part, with conditions of the environment in a market economy, and in the second part, with the business leader's and entrepreneur's role and task. Both aspects affect and influence each other. Related thereto, I shall set forth, at the end, certain postulates in the form of a thesis for sustainable economic evolution.

**Conditions within the environment of the State.** In recent months, there has been much talk about "historical change." While, as a contemporary, one should be moderate in the historical evaluation of current events, there should be no doubt that, in the late 1980s, there was a valid response to a question that had prevailed during an entire era of economic development and that, specifically in Latin America, led to risky experiments with costly consequences: how to organize a country's economy to achieve the best possible way to create wealth, in order to assure the well-being of the majority of the population?

The spectacular collapse of communism was, more than anything else, a consequence of its overwhelming economic failure. After decades of effort and despite repeated attempts at reform, the concept of an economy planned and directed centrally by the State, which is an important part of the communist political program, proved to be totally ineffective for the creation of sustainable economic development. Various factors are responsible: the slowness of the bureaucracy, which was set up to centrally plan and control, and which spread through the State like a cancer, and the peoples' lack of motivation and inclination to generate output, since they had to perform their work subject to the coercion of a central national hierarchy. Fortunately, there are nations that have organized their economies in accordance with an idea which is fundamentally different from that of the concept of communism. They allow for comparison of systems, and are also models which, having been proven in practice, serve as an example for those who want to begin economic reconstruction.

The market economy, as a concept, is not defined in all its details. With its liberal character, it is capable of transforming and renewing itself and can adapt some of its aspects to the specific circumstances of a nation and to the desires and ideas of its people.

Decentralized decision making is one of the necessary and unwaivable elements of the market economy. Hence, economic decisions are not made by a government agency, but by various institutions that are independent of each other. First, there are the *consumers* who make the relative scarcity of goods and services known by their preferences, thereby establishing the basis for pricing. Therefore, the entire population participates in the economy's operation to the extent that they participate in consumption.

In the market economy, the *production* of goods and the supply of services are also organized in a decentralized manner, in the form of independent companies, in which human beings, knowledge, and technology optimally combine to create additional economic values.

There are companies of the most varied types, differentiated from each other in many ways: by their size, their ownership structures, and so forth. As the needs of the market and the conditions of its environment change, so do companies. They grow, merge, restructure, and some disappear for one reason or another; only the most innovative and vital survive.

For an economy to prosper, the process of corporate creativity, growth, and innovation must be facilitated as far as possible. That process means nothing but the continuous optimization of the economic structures and their efficiency. In the competitive environment of the market, the one who performs best under given conditions will be the one who succeeds in using the available production factors with the greatest capacity for output - in other words, the one who can do a specific job with the least possible amount of effort.

A similar experience applies to economic competition among nations. Experience teaches us that possessing natural resources and a large work force are not the only basic ingredients needed to achieve the success and well-being of a nation. Competition among nations primarily affects the conditions of the environment that countries impose on the economy. In addition to a hard-working population, the most important conditions for achieving sustainable economic growth and a favorable outcome in international competition are: a free market-oriented economic policy, minimal government participation in the social product, government institutions that operate efficiently and are trustworthy, and the proper infrastructure.

Countries that succeed in implementing and maintaining such an economic plan and the corresponding institutional structures offer the best conditions for creation, growth, and endurance of companies. This increases their ability to attract investments of domestic and foreign capital. A market that functions well forces companies to be competitive and, therefore, productive. The productive use of resources makes possible optimal creation of wealth and entails positive and extensive economic development.

The 1980s are considered a lost decade for Latin America. Leaving aside the oppressive burden of debt, this loss occurred mainly because the Latin American countries did not create the political and institutional conditions for positive development of their economies. The few exceptions, among which Chile stands out, unfortunately confirm the rule. Too often in Latin America, the concepts of market economy, democracy, and liberalism have been misused. These concepts were used only as a pretext for maintaining the structures of entrenched interests, protectionism, and mercantilist behavior. These days, the superiority of the liberal economic system as a solution to the Latin American crisis has already been proven. Now it remains to identify the way in which a people that have traditionally been characterized by their patriarchal and interventionist form of government, even traces of totalitarianism, can find the road to modern constitutional government with a productive market economy. In the search for this new path, the traditional bases of political and economic power are, as a rule, not worthy of confidence, inasmuch as they generally learned very well how to use the old system to their own advantage.

I cannot, nor do I want to, prescribe a formula for a political plan in Latin America, especially because each country has its own unique set of circumstances. Nevertheless, I believe that my professional colleagues, the business leaders and entrepreneurs, can and should contribute heavily to the creation of a free market-oriented market economy.

**The business leader and entrepreneur's mission.** Business people play an important role in the economic system. Within their sphere of activity, they are an indispensable part of any decentralized economy. Through their work, they participate creatively in structuring the economy. Because of their own market orientation and proven competence, they further, in their own interest, the productive, efficient use of the country's resources, being innovation, and thus contribute to the ongoing development of the economy.

The fundamental task of small and large businesspeople lies in the microeconomic sphere.

They structure and direct the "microcosms" of their businesses as pieces of a whole, the economy. In turn, they are subject to countless circumstances and influences which they must study when they make decisions that limit their field of action: governmental legislation, customers, colleagues, associates, shareholders, public opinion, and many more.

Traditionally, business leaders and entrepreneurs have been fundamentally receptive to influences coming from their surroundings. They have tried to make use of them when beneficial and to avoid them when they considered them counterproductive. But first and foremost, they sought to benefit from and extend their sphere of business activity. In general, they concerned themselves with policy only when it affected their own interests, and preferred to become involved in the public opinion process only under favorable circumstances.

Businesspeople have considered themselves "*homo economicus*," and their work and success have always been defined by numbers; their responsibility has been limited to their sphere of influence in the business, and the ultimate evaluation of their work has been the profits generated by their companies.

But in recent years, business leaders in large companies, and especially those doing business internationally, have become increasingly involved in discussions outside their traditional sphere. So, they have been asked to explain and document the meaning and legitimacy of their function in economic life. Lately, businesspeople have been encouraged to help reorient economic development toward sustained growth. And, in general, in the world of communications, they have been expected to meet their obligations to the environment, in which they operate.

In addition to that new expanded professional image of the business leader and entrepreneur, experiences and opinions regarding the role of the government also need to be presented and discussed. As a result of their practical professional activities, and also as citizens in a liberal system, business leaders and entrepreneur are able and even obligated to offer their well-founded opinions on economic concerns.

This means that they don't just want to represent their own interests and those of their companies. Businesspeople of the new school have recognized that they must contribute to the lasting positive development of the general conditions of the global economy in order to best achieve their own interests.

**Preserving the environment.** Besides the obvious need in Latin America to implement political and institutional reforms, in order to guarantee economic growth, there is another aspect that will become increasingly pivotal in the development of these countries and in the function of the business leader or entrepreneur. It is the need to reconcile economic growth with environmental law.

When there were almost unlimited quantities of fresh air, clean water, energy, raw materials, and large areas available for dumping all kinds of waste, attention to the environment was not

an important political issue. This situation has undergone a fundamental change in just a few years. The serious damage to the natural environment on every continent is immeasurable. So, it is not necessary to cite examples. Only those who stick their heads in the sand can fail to bear witness to the destruction of Nature.

Until very recently, the protection of the environment coincided with the preservation and conservation of the natural environment and natural species. Nowadays, the expansion of human civilization is considered practically equivalent to the destruction of Nature. The limitations and prohibitions imposed on economic development have been the inevitable result of this focus on the "society of abundance" by the wealthy industrialized nations.

However, a global perspective must consider the needs of human beings in developing countries and their legitimate interest in improving their standard of living. Economic objectives should correspond to environmental protection objectives. This gave rise to the idea of "sustainable development," which should make it possible for the current generation to satisfy its own needs without destroying the opportunities of future generations.

This concept, seen as an objective, is simple and convincing. It accepts and combines the desire for economic development and environmental protection. But the simpler the concept is, the more difficult it is to apply, since much of our industry and consumption habits depend on the destruction and contamination of Nature.

We will need to fundamentally change these behaviors. In simple terms, we need to reduce consumption of raw materials and energy and ensure that our productive processes become cleaner and more efficient, recycling a large part of their waste. This means, first of all, additional expenditures, since destruction and pollution are often cheaper in the short term. But this is so only as long as consumption and the destruction of natural resources do not come at a price. In the long run, we all know that this cannot continue.

Personally, I do understand that, in some way, the developing countries demand that the industrialized nations ensure that their economies are compatible with the environment, inasmuch as they have just a quarter of the world's population but consume three fourths of the world's energy and raw materials. The argument is that the developing countries lack the means necessary to protect their environment and need to give priority to improving their standard of living.

The fact that I understand this attitude does nothing to change the fact that it comes from a short-term perspective and that, therefore, it is not sustainable over the long term. When we speak of the development of the Third World, we generally mean "*mutatis mutandis*" that it involves the transfer and application of the industrialized nations' experience. But this cannot and should not mean that the developing countries should apply models that have failed in the interim. As a consequence of population growth and the constant acceleration of progress, environmental degradation in the developing countries would become even greater if they committed the same errors as the industrialized nations. Could it be that the opportunity for the developing countries, in the future, is to benefit from the lesson of the errors committed by the industrialized nations?

In the near future, when vast areas of our planet have reached Nature's overload limit and many countries are faced with the costly consequences, an intact environment will be a significant international competitive advantage. Within the framework of an economic development plan, maintaining this advantage must be the primary objective of the Latin American countries. Soon, the protection of natural resources will also bear economic fruit, since the creation of well-being by consumption and the destruction of natural resources is only an effective short term solution.

The call for sustainable development appropriate to the environment in the Third World does not mean just applying the most modern non-polluting technologies, often developed in the industrialized nations to correct existing damage. Instead it means developing their own forms

of civilization and industry appropriate to the environment, in accordance with the specific conditions that prevail in the developing countries, where capital is scarce while labor is abundant.

**Businesspeople and progress in Latin America.** The 1990s are expected to be a time of prosperity for Latin America, not just from the economic point of view but also as a decade of environmental innovation. A decade that can create a new base for the ability to compete internationally could become an undisputed foundation by which this continent, so rich in human potential, size, natural environment, and raw materials, would gain a great advantage over the rest of the world, provided that this advantage is preserved and used in a prudent, sustained manner.

Business leaders and entrepreneurs can play an important role in this process of innovation in Latin America. They can contribute in various ways to help the government create the proper conditions, so that business becomes inclined to invest in sustainable development in harmony with local circumstances. But they must also develop models for sustainable growth at the microeconomic level. This means having a long-term vision, a vision that is focused not just on the next quarterly dividend, but also on opportunities for future generations.

This way of thinking and acting, very familiar in private life, should prevent the continued sacrifice of Nature without any regard to short term improvement in the standard of living. Business leaders and entrepreneurs who invest in the future on the basis of available current knowledge must demonstrate, in their plans and calculations, not just the feasibility, but also the sustainability of their projects. Those who are winners in the future will be those who invest in this principle today, undertaking on their own initiative something creative, which others will also be required to do in the not-too-distant future.

**Characteristics of sustainable development.** Gradual implementation of the concept of *sustainable development* will be a major challenge to future generations. In the search for the road to *lasting, equitable* progress, we need to be guided by a long-term vision. The objective of our efforts will be to follow this path. The "pioneering nation" in the field of sustainable development should have the following characteristics:

1. Through economic policy, clearly directed towards a market economy, with institutions worthy of confidence, government creates the conditions for extensive development of business activity. This sweeping institutional reform makes the conditions of its environment more attractive over other countries.
2. In a system of free competition, economic wealth is created on the basis of private initiative, through corporate self-direction. The government extensively promotes creation and growth of all sizes and types of companies. Opportunities to access markets increase for all. National social policy directly assists those who are truly in need, without paralyzing private initiative or altering the market rules.
3. Businesspeople make their decisions on the basis of economic feasibility as well as ecological sustainability. Their current decisions take into account foreseeable future expenses that would be caused by the destruction of Nature as well as the expected benefits of protecting the environment.
4. Society - government leaders, politicians, business leaders, entrepreneurs, citizens, colleagues, associates, and consumers - concerns itself not only with its own well-being, but also with that of the children. Therefore, it protects the environment for its descendants' sake. It also ensures the quality of environmental conditions, since they determine the scope of decisions. This will shape the new breed of future business leaders and entrepreneurs.