Three Essays on Governance in South America

by

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Abstract

This dissertation consists of three essays that address selected topics on the governance of Brazil, Chile, and Argentina. The first two papers cover specific aspects of the role of business groups and their relation to individual and state investors. The third paper considers the relationship between the legislative oversight of the bureaucracy and electoral and party systems across Brazil and Argentina.

The first essay introduces business groups and their role in economic development. Business groups consist of a set of legally independent firms bound together by equity and social ties and usually organized in the form of a pyramid with a controlling shareholder at the apex. The controlling shareholder is often a wealthy family that owns large blocks of shares and controls the decisions over all the firms of the group. The collective value of the group is far beyond the actual wealth of the family. This concentration of ownership and control contrasts with the usual American corporation wherein ownership is diffuse and control is in the hands of managers. A significant part of the literature supports the thesis that business groups are more prevalent in countries with lower levels of investor protection. According to this view, weak legal support for the rights of individual investors is conducive to better economic returns for business groups. More generally, it is often claimed that the evolution of business groups is tied to the nature of investor protection. *The objective of this paper is to verify whether the evolution of investor protection is a good candidate for explaining the evolution of business groups in Brazil, Chile, and Argentina between 1990 and 2003.* The three countries belong to a region where business groups are predominant and investor protection is amongst the weakest in the world. However, *this paper concludes that investor protection, the usual suspect, does not explain the evolution of business groups in*

the countries and period under study.

If investor protection is not a candidate for explaining the differences in the evolution of business groups, what is? The second paper looks at the role of the state in financing business. Most business groups in Brazil, Chile, and Argentina emerged in the middle of the twentieth century, fostered by import substitution industrialization policies. They grew at the end of the same century due to privatizations programs. Since then, business groups in Brazil have emerged and expanded due to privatizations and internationalization. In Chile, the biggest business groups have expanded due to internationalization, privatizations, and mergers and acquisitions. In Argentina, many business groups that had grown through privatizations had to sell part or all of their assets due to mergers, acquisitions and financial distress. *This second paper argues that their different pattern of evolution over the period between 1990 and 2003 can best be explained by the differences in state involvement in business (equity) financing.* In Brazil and Chile, the state provided equity financing, directly through public institutions in Brazil or indirectly through foreign owned pension funds in Chile, and business groups fared well. Indeed, equity financing policies affected the governance structure of business groups in these countries. They allowed for equity financing from domestic sources without losing control of corporate decisions, while simultaneously keeping bankruptcy risk under control in face of negative external financial shocks. In Argentina, despite the potential benefits of equity financing, pyramidal business groups were mainly financed through foreign credit and fared badly. They were highly indebted in foreign currency and crowded out from financial resources by the state, in face of negative external financial shocks.

In the third paper, I move away from the study of policies, the economy, and the role of

the state in financing business groups, in order to consider how differences in electoral and party systems can affect legislative control of the bureau. *The objective of this paper is to analyze the use of the constitutional methods in the hands of the legislative power to oversee the bureaucracy in presidential systems and compares the controls used in the United States with those practiced in Argentina and Brazil.* The study stresses the role of variations in the electoral and party systems across different presidential systems, to explain differences in legislative control across countries. The electoral and party systems make legislative and executive branches of power separate in the United States, intertwines them in Brazil, and subordinates the former to the latter in Argentina. In the U.S. presidential system, the *de jure* separation between powers is complemented by a plurality rule electoral system biased against coalition government. This results in a system of legislative control of the bureau autonomous from the executive, consistent with separation between legislative and executive branches. Both South American countries have proportional representation electoral systems. This configures multiple political parties. In Brazil, open lists of candidates for election imply that candidates elected to Congress have fewer obligations towards their parties. They can negotiate their membership in multiparty coalitions, including the governing one. As long as the government coalition in Congress remains unchallenged, it assures discipline amongst the majority of legislators to the coalition and legislative support to the president. Thus, the government coalition in Congress intertwines these two branches. As a result, legislative control of the bureau that combines controls common in the United States with controls common in parliamentary systems, is in the hands of the government coalition. In Argentina, closed lists for elections mean that party leaders control candidate positions on a list as well as their careers once they are elected. Among the multiple parties, the Peronist

party is dominant and often governs with legislative majority. This allows its leaders to be assured of legislators' obedience in Congress and of their support to the president that tends to concentrate executive and legislative powers. Legislative oversight of the bureau, mainly composed of elements common in parliamentary systems, is responsive to the president. *Legislative oversight is in the hands of Congress in the United States, the government coalition in Brazil, and the president in Argentina. Legislative oversight is a reflection of the electoral and party systems in the three countries.*

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May 2016

Dedication

To Lucas

To the memory of

Bruno, Caterina, Fausto

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Introduction to the Dissertation

My decision to pursue doctoral studies was triggered by a personal need to explain the crisis that hit Argentina in the early 2000s. I witnessed the economic and social transformations that took place in the country and in the region over the period of market oriented reforms in the 1990s. My perspective was not that of a citizen. I was a young economist working for the bureaucracy within the national government in the historical center of Buenos Aires.

In the early 1990s, I wrote many reports on the numerous reforms that were taking place in almost every aspect of the economic system. My office was a block away from Plaza de Mayo, the historical square where demonstrations against the reforms far outnumbered by the time those of the *Madres* still searching for their missing children. In the late 1990s, I was in charge of inquiries related to antidumping and safeguards. I dealt with the lobbying aspect of the economic sectors that sought market protection in times of trade liberalization. My office window looked out onto the main customs building and Paseo Colón Boulevard, where thousands of people would protest against the government. I was in that office when I learnt about the resignation of president De la Rúa in 2001, some weeks after the 11/9 event.

From my perspective at the time, neither Argentina nor the world appeared to be in a very promising condition to begin the new millennium. Apart from a few exceptions, the explanations of the experts I listened to were not at all convincing. They were sometimes based on comparisons across Argentina, Brazil, and Chile. I suspected something important was hiding behind these comparisons and wanted an explanation that would highlight the underlining causes of the differences across the countries. In 2004, my husband and I moved

to Canada. In 2009, I was admitted to Carleton. We celebrated the event at an Irish pub in downtown Montréal. Indeed, a long and relentless path was to precede this dissertation.

Due to my job at the *Comisión Nacional de Comercio Exterior* between 1998 and 2004, my research interests were naturally focused on public policies towards business. I was particularly concerned by business-government relations and by the way in which the state bureaucracy worked, was influenced by business, and controlled by governments. The *Comisión* demonstrated in Rianne's words an 'unequal structure of representation' (Mahon 1979) and within this structure the representation of different business interests was also unequal. The most privileged ones were business groups, which constitute the most prominent form of private conglomerates in Latin America. They consist of a set of legally independent firms bound together by equity and social ties and usually organized in the form of a pyramid with a controlling shareholder at the apex. The controlling shareholder exerts control over all the firms of the group, whose collective value is far beyond the actual wealth of the controlling shareholder (Khanna and Yafeh 2007). This structure differs significantly from the American corporation, wherein ownership is diffused among many shareholders and control is in the hands of managers.

The first two essays cover specific aspects of the role of business groups. *In the first essay, I ask following a thesis supported by a significant part of the literature whether the evolution of investor protection is a good candidate for explaining the evolution of business groups in Brazil, Chile, and Argentina between 1990 and 2003. I find that investor protection does not explain the evolution of business groups in the countries and period under study. My research contributes with the rejection of a usual hypothesis on business groups' evolution based on empirical data from Latin America.*

In the second essay, I ask what the explanation is for the differences in the evolution of business groups across the three countries, if investor protection is not. I argue that the different pattern of evolution over the period between 1990 and 2003 can best be explained by the differences in state involvement in business (equity) financing. In this work, I add to the literature on the 'political economy of corporate governance' a capital markets emphasis and I build new statistical evidence for business groups in the three countries under study using the databases from the Economatica system.

In the third essay, I move to the study of controls over the state bureaucracy. I asked whether the constitutional methods in the hands of the legislative power to oversee the bureaucracy are similar across presidential systems. I argue that there are differences in legislative oversight across countries and they can be explained by variations in the way electoral and party systems work across different presidential systems. My study suggests that controls designed for a separation of power system and applied where powers are closer or concentrated may jeopardize democratic accountability. This constitutes an original application of the institutional approach to developing countries that links institutional design to democratic accountability.

In each essay, I consider the research question, the arguments, the gaps in the literature addressed, the methodological approach, the sources of data used, and the academic contribution. As always, additional quantitative work beyond that introduced later as well as other sources of data such as interviews would be helpful. Hopefully, they will be included to further the research in the future.

The following pages present a brief historical introduction to the political economy of business groups in Brazil, Chile, and Argentina, as a preface to the rest of the dissertation.

Introduction to the Political Economy of Business Groups in Brazil, Chile, and Argentina

In the largest countries of Latin America, the emergence of many business groups is related to the implementation of import substitution industrialization policies (ISI) between the 1940s and the 1970s. These policies included the creation of state-owned enterprises (SOE), domestic market protection, and loans at subsidized interest rates for domestic firms. Despite their initial success, ISI policies revealed their weaknesses in the 1970s. Higher interest rates and lower prices for commodities in the 1980s made many Latin American countries unable to service their external debts and the region fell into economic stagnation. Brazil, Chile, and Argentina were not exemptions.

Most governments in the region turned to market-oriented reforms in the 1980s and 1990s in their quest for macroeconomic stability and development. These reforms, frequently a prerequisite for obtaining loans from multilateral banks, included privatizations and trade and financial liberalization. Business groups often welcomed the reforms, expecting winning with privatizations while circumventing the threats of trade liberalization.

Business Groups in Brazil

Although business groups had been present in Brazil since the late 19th century, most of the existing ones have emerged between 1940 and 1970 as a result of industrialization policies.

Under the presidencies of Getúlio Vargas (1930-1945 and 1951-1954)¹, many SOE were created in sectors considered strategic. *Vale do Rio Doce* in mining, *Companhia Siderurgica Nacional* in the steel sector, and Petrobras in the oil and gas sector are noteworthy examples. Under the presidency of Juscelino Kubitschek (1956-1961), industrialization policies focused on oil, steel, cement, infrastructure, and car manufacturing sectors. In the electric energy sector, the SOE Eletrobras was created. During this period, not only did the state lead industrialization, but also the organization of labor and business interests². Business representatives cooperated with the government through formal and informal channels. Some of these representatives became public officials (Schneider 2004, 100- 103).

In the meantime, economic and political instability had surfaced and brought about the *coup* of 1964 that triggered a 20-year military regime³ (Diniz 2011, 60). Industrialization policies during the first decade of the military government (1964-1985) were focused on railways and energy infrastructure as well as on the creation of the SOE Telebras in the telecommunications sector (Aldrichi and Postali 2010, 354). During this period, employee discharge was made simpler by changes in labor regulations (Skidmore et al 1984, 338). Meanwhile, businessmen interacted through personal channels with bureaucrats in high-level executive positions (Leff 1968, 111; Schneider 2004, 108).

¹ For details on Vargas' administrations and his *Estado Novo*, see Skidmore et al (1984).

² The state organized labor controlling its finance, the election of its members and allowing only one union per plant, as established in the Labor Code of 1943. It also organized cartels of producers of coffee, cocoa, sugar, and tea (Skidmore et al 1984, 328). Industrial associations at the federal level were structured by the industrial businessmen from São Paulo, who were main supporters of ISI policies (Schneider 2004, 102).

³ There is no consensus about the role of business in the *coup*. Some argue that it was orchestrated by business, others consider that business was part of the supporting coalition, still others ignore the role of business in the event (Schneider 2004, 107).

One feature of the industrialization in Brazil was the pre-eminence of foreign capital in car manufacturing, pharmaceutical, chemical, and petrochemical sectors (Haber 2006, 570-580). This fact made some scholars argue that “international capital is an integral part of the ... Brazilian economy [... and its] representatives ... are an integral part of the Brazilian political and social order” (Evans 1979, 9).

Domestic business benefited from the spillovers generated by the industrial development in public and foreign hands. Under domestic market protection, they produced textiles, leather goods, appliances, electric machinery, metalworking, cement, glass, pulp and paper (Haber 2006, 570-580) and financed their operations through subsidized credit (Aldrichi and Postali 2010, 360).

The *Banco Nacional de Desenvolvimento Economico*⁴ (BNDES) was the main public agency for business financing⁵. It financed infrastructure, transport, electric energy, and other basic industrial sectors as well as the production of intermediate and capital goods (Lopez and Rougier 2012, 17-22). In addition to the policies towards business already mentioned, the existence of the bank allowed the state to monitor and influence the development of domestic business and the formation of business groups. Many of them managed to survive the international financial crises of the 1970s and 1980s thanks to BNDES bailouts, but others were wiped out (Stallings 2006, 222; Aldrichi and Postali 2010, 368).

⁴ It was created in 1952 as *Banco Nacional do Desenvolvimento Economico*. Since the 1980s, it also finances projects with social components and is called *Banco Nacional do Desenvolvimento Economico e Social* (BNDES).

⁵ Business groups were also financed by foreign loans and rarely by Brazilian private banks. The latter found better returns in government bonds. The capital market was not an interesting option because it was underdeveloped.

Indeed, these crises made ISI policies no longer sustainable.⁶ Business interests encouraged the retreat of the state and of the military⁷ so democracy could return to Brazil by 1985. Several businessmen who opposed the military regime were elected or appointed officials to the new democratic government (Schneider 2004, 112-4).

A large-scale privatization program was put in place in Brazil in the years that followed. The main motivation was macroeconomic in nature, in particular the government's need to balance fiscal accounts by maximizing revenues through sales of SOE while reducing the entrepreneurial role of the state (Anuatti-Neto et al 2005, 146).

The implementation of the privatization program was carried out in two stages and SOE were selectively targeted. The first round of privatizations began in 1991, under the presidency of Fernando Collor de Mello. During this round, privatizations included federal SOE in the steel, fertilizer, and petrochemical sectors and attracted mainly domestic business groups. The second round initiated in 1994, under the administration of President Fernando Henrique Cardoso. During this round, privatizations included more firms owned by the federal government in energy, mining⁸, oil and gas, and infrastructure sectors. Firms owned by the states were included in 1996. Telecommunications firms owned by the federal government were included in 1997. The latter attracted foreign capital (Anuatti-Neto et al 2005, 146).

⁶ The private sector external debt was nationalized and the currency devaluated twice.

⁷ In 1978, a group of business leaders endorsed a manifesto with this petition.

⁸ This included Vale do Rio Doce. Despite its initial privatization in 1997, the consortium that acquired Vale later transferred its control to Valepar. The latter is a private company jointly owned by several state related pension funds and financial institutions and three Brazilian business groups (Bradesco, Opportunity and Vicunha). Although this study covers the period 1990-2003, it is worth noting that by the end of the period, the Brazilian state was taking back control of the firm without resorting to any direct mechanism of nationalization or expropriation. By 2008, state related entities controlled more than 60% of Valepar's voting capital, which in turn owned 54% of Vale's voting capital. Further, the Federal Government held a golden share (Aldrichi and Postali 2010, 373).

The Brazilian program of privatizations was among the largest in the world, not only in absolute terms because of the size of the Brazilian economy, but also in relative terms. Between 1991 and 2001, the state transferred the control of more than a hundred SOE representing 5% of the GDP to domestic business groups and to foreign owners (Lora and Panizza 2002). Most of the electric energy distribution and telecommunications sectors were transferred both to foreign owners (with more stakes in telecommunications) and to domestic business groups (with more stakes in electric energy)⁹.

In order to participate in privatizations, the Brazilian state favored the domestic business groups in terms of financial assistance. The BNDES and state related pension funds such as Previ (Banco do Brasil pension fund), Petros (Petrobras pension fund), Funcef (Caixa Economica Federal pension fund), Valia (Vale pension fund) and Sistel (Telebras/Embratel pension fund) acted as funding for the bidders. This resulted in their participation in coalitions of controlling shareholders of privatized firms and in a partnership between business groups and the state, wherein the latter became a minority shareholder of formerly SOE (Aldrichi and Postali 2010, 368; 373; Hochstetler and Montero 2013).¹⁰

Despite the extensive privatization program, the state retained the control over the natural resources sector, including the oil and mining industries. It also retained the control over key firms in the banking sector (BNDES, *Banco do Brasil*, and *Caixa Economica Federal*) and the electrical energy sector (Eletrobras, *Companhia Energetica Mina Gerais*, and *Companhia Paranaense de Energia*); and over firms operating in transport infrastructure, communications, and health services (Anuatti-Neto et al 2005, 146-148).

⁹ Privatizations revenues mostly came from the electricity (35%) and telecommunications (27%) sectors (Anuatti-Neto et al 2005, 152).

¹⁰ Later, the state also supported the restructuring, modernization, and internationalization of business groups through state procurement and financing (Aldrichi and Postali 2010, 379).

Workers were excluded from the opportunities derived from privatizations because the program did not resort to public offers in any significant degree (Anuatti-Neto et al 2005, 167-168). Some public sector liabilities relating to current and future pensioners of the social security system could have been exchanged for shares of privatized SOE. Only in the late 1990s were workers allowed to access their deposits in public offerings so as to obtain shares of Petrobras and Vale (Anuatti-Neto et al 2005, 167-168).¹¹

In the late 1990s, a consensus emerged among business representatives that market oriented reforms had privileged the financial sector over the industrial one, and that many firms had been damaged and subject to profound restructuring without adequate governmental support¹². As a consequence, business representatives began to ask for industrial and export promotion policies (Diniz and Boschi 2003, 10-17). Yet, the international financial crisis was highlighting more urgent needs, such as that of avoiding default of foreign debt and devaluation (Skidmore et al 1984, 344). Economic instability lasted until 2002 when Luiz Inácio Lula da Silva, the first working-class president of Brazil, demonstrated that he had the support not only of workers, but also of both the banks and the industry.

Over these decades, business groups participated in major political regimes changes, as members of business associations or as individual businesses. Their representatives, especially those from the São Paulo industrial sector, took part in all kinds of governments through prominent positions. They never faced significant challenges due to labor, leftist politics, or arbitrary state actions (Schneider 2004, 96-97).

¹¹ For this reason, some scholars argue that despite that one of the objectives of the privatization program was to promote public ownership of former SOE and ‘democratize’ capital ownership, the actual engagement of the government with this objective is hard to affirm (Anuatti-Neto et al 2005, 146; 167-168).

¹² Among the sectors most damaged were electrical goods and equipment, footwear, clothing and textiles.

Business Groups in Chile

In the late 19th century, private initiatives created the first business groups in the natural resources sector. Yet, the most important industrialization policies were carried out between 1940 and 1960 by the *Corporación de Fomento de la Producción de Chile* (CORFO). Through this public agency, the government created SOE and mixed-ownership firms (Teichman 2001, 25; Fischer et al 2005, 206), launched investment projects for the development of infrastructure, and promoted metalworking and petrochemicals industries (Silva 1996, 34).

Among the most important SOE created over the period, it is worth mentioning *Empresa Nacional de Electricidad* (ENDESA); *Empresa Nacional de Telecomunicaciones* (ENTEL); *Empresa Nacional de Minería* (ENAMI) operating in mining; and *Empresa Nacional del Petróleo* (ENAP) operating in the oil sector (Fischer et al 2005). Domestic firms grew in the fields of metalworking, petrochemicals, and textiles (Silva 1996, 35), protected by external competition and financed by CORFO thanks to foreign savings¹³. Foreign capital also participated in the industrialization of the country through steel companies and the exploitation and exportation of copper and coal. Traditional businesses groups continued operating in oil, mining, fishing, agriculture, retail, pulp and paper (Skidmore et al 1984, 297).

By 1960, landowners and industrial/financial businessmen from the same landed elite dominated the country's economy. A demand arose for land redistribution and changes in property relations (Teichman 2001, 76). In the mid-1960, successive governments shifted

¹³ Between the 1930s and the 1960s, foreign savings for development favored industrialists over landowners and other sectors. Most funds came from bilateral/multilateral lending institutions through CORFO (Silva 1996, 38).

from ISI policies towards a greater state ownership and control of the economy, away from foreign companies and domestic business groups. Between 1965 and 1970, a land reform resulted in the expropriation of more than 20% of the arable land that was kept almost entirely in public hands. In 1968, the Copper Corporation of Chile (CODELCO) bought 50% of the shares of the four largest copper mines in the country¹⁴. In 1970, CORFO bought the firm Chilectra and the state became the owner of almost the entire electric power sector. That same year, the role of the state in the economy went even further with the presidential election of Salvador Allende.

During his administration, many private banks as well as foreign-owned companies operating in copper, coal, and steel sectors were nationalized through acquisition or expropriation (Fischer et al 2005, 205). By 1973, the state controlled no less than 40% of the GDP¹⁵ (Fischer et al 2005, 206; Skidmore et al 1984, 297) in a social climate increasingly determined by political violence and economic crisis. Some groups saw social transformation “threatened by entrenched property interests” while others feared “social chaos and the loss of political and property rights” (Skidmore et al 1984, 295; Teichman 2001, 65). In September 1973, a military *coup* overthrew Allende and initiated Augusto Pinochet’s dictatorship that would last almost two decades.

Under military rule, a comprehensive process of privatizations began in the early 1980s. The goal was to re-privatize firms that had been nationalized under Allende’s government, transfer most of the SOE to the private sector while maximizing state revenues, develop a capital market, and privatize the provision of social services (Fischer et al 2005,

¹⁴ At that time, copper represented over 80% of Chilean exports. Today, CODELCO is a Chilean SOE and the largest world producer of copper (11%) owning the largest world reserves (20%) (Fisher et al 2005, 204).

¹⁵ 441 firms, 15 banks, and 66 agro-industrial plants. CORFO was minority shareholder in 70 firms and 4 banks. The state owned 9 millions of hectares (Fisher et al 2005, 206).

207). Under Pinochet, the implementation of the privatization process underwent two rounds: the first took place between 1974 and 1981 and the second between 1985 and 1989. A third round of privatizations took place under democratic government between 1994 and 2000.

During the first round, over 250 banks and firms were restored to former private owners.¹⁶ Over one hundred non-financial firms acquired by the state since the 1960s were sold. Half of the SOE that were in public hands before 1970 were also privatized. During this phase, the social security system was also turned into a mandatory funded capital system, run by private pension funds. The state retained those firms in sectors considered to be strategic, such as electricity, telecommunications, mining, steel, railways, shipping, and the national airline (Fischer et al 2005, 198).

In this first phase, the privatization program included lending money to the buyers¹⁷ (Fischer et al 2005, 207). This fostered not only the re-emergence of some business groups, but also the emergence of new ones. Organized around financial institutions, prominent business groups captured domestic and international savings to buy existing firms, rather than set up new ones (Silva 1996, 161). The political coalition behind this first round of privatizations was formed by businessmen linked to new business groups such as Cruzat-Larraín, BHC, Edwards. These businessmen belonged to the resistance against Allende and collaborated with the military (Silva 1996, 159). These new business groups came to control half of the Chilean banks and 70 of the largest firms in mining, agricultural exports, and

¹⁶ The land expropriated was returned to former owners (28%), divided and sold at subsidized prices (52%), and privatized or transferred to the National Forestal Corporation (20%) (Fischer et al 2005, 206).

¹⁷ Only 10-20 % of the bid was required immediately, there was a 1-year grace period and 7 years for full repayment at a low interest rate. The loan guarantee was 150% of the loan value, but it could be in shares (Fischer et al 2005).

forestry (Teichman 2001, 77). Cruzat-Larraín and BHC grew from eleven and eighteen companies in 1974 to 85 and 62 in 1977, respectively (Silva 1996, 161).

The international crisis of 1982, triggered by the rise of the international interest rate and amplified in Chile by mistakes in public policy, led to the reversal of privatizations (1982-1984). The privatization process had been carried out without an adequate legal and institutional environment and led to a concentration of property and to highly leveraged conglomerates (Silva 1996, 162; Fischer et al 2005, 208). As international interest rates climbed and capital inflows stopped; firms in real state, commerce, industry and agriculture as well as the small financial institutions that provided them with capital began to go bankrupt. The financial institutions supporting larger conglomerates also became insolvent, although initially borrowing from themselves and crowding others out¹⁸ (Silva 1996, 161).

The state intervened and took over many institutions, guaranteeing their foreign loans, and rescuing local deposits. Several private pension funds and dozens of non-financial firms were also taken over. As a result, the state once again controlled banks and firms, many of which had been recently privatized (Fischer et al 2005, 208). Some business groups were dissolved (Vial and BHC groups), others shrank in size (Cruzat-Larraín group), and other financially stronger ones consolidated (Angelini and Luksic groups) or emerged (Lefort and Walker 2007, 389-393). This would have an impact on the coalition behind power.¹⁹

As a consequence of the 1982 crisis, the second round of privatization took place in a more regulated environment, highlighting corporate and securities regulations in particular.

¹⁸ The banking system made it easy for banks to lend money to related firms. 21% and 50% of all loans of the two main banks went to related firms (Fischer et al 2005, 208).

¹⁹ Even if it is beyond the scope of this work, it would be interesting to compare the evolution of business groups during the first round of privatizations in Chile with the evolution of business groups during the 1990s in Argentina.

This resulted in a separation between financial and industrial business and limited the concentration of ownership. Other related policies included domestic market protection, export incentives, debt relief, and regulation of interest and exchange rates (Lefort and Walker 2007, 389-393; Chong and Lopez de Silanes 2007, 17). Over this period, the privatization program reached major SOE including 13 electricity firms, three telecommunications firms, and the national airline *Línea Aérea Nacional de Chile* (LAN), amongst others (Fischer et al 2005, 210). Banks, insurance companies and pension funds that had been taken over by the state during the 1982 crisis were also re-privatized.

Privatized firms went to domestic business groups, foreign owners, or joint ownership structures particularly in the major acquisitions. The second round of privatizations gave rise to new business groups and was supported by a broader business coalition including businessmen in industry, agriculture, and construction (Teichman 2001, 78; Lefort and Walker 2007, 390-3). During this period, pre-*coup* conservative business groups were closely linked with the government and it was not unusual that government officials became directors of firms in several of these business groups, rather than be exclusively associated to a single one (Silva 1996, 166).

The period 1990-2003 was marked by democracy and growth. After opposing to one of the most extreme dictatorships violating human rights in the region, a coalition of parties won the first presidential election in twenty years and almost stopped privatizations between 1990 and 1994. This coalition faced the problem of how to maintain business sector confidence and avoid antagonistic relations with business groups that had benefited from the military regime. The solution found by the government was interacting with a peak business association rather than with individual business groups (Silva 1997, 173).

The third round of privatizations (1994-2000) took place under the second democratic government that made further changes to regulations, affecting corporate and securities laws (Chong and Lopez de Silanes 2007, 17). Privatizations reached the three largest water and sewage companies along with many transportation companies, including shipping and cargo railway firms (Fischer et al 2005, 211-212). Behind these policies, there was a state bureaucracy formed by officials and businessmen linked to political parties (Silva 1997, 178). Trade unions were still excluded from the policy networks (Teichman 2001, 190).²⁰

Despite the extent of privatizations in Chile, the state did not retire completely from the productive sector but retained the control over natural resources and almost 40 firms representing 9% of GDP in all, by the late 1990s (Fischer et al 2005, 199; 211). The most important among these firms were the copper company CODELCO, the oil company ENAP, the coal company ENACAR, the commercial bank *Banco del Estado de Chile*, and nine regional water/sewage firms (Lefort 2010, 411).

Business Groups in Argentina

The first business groups to emerge in Argentina were those in export-oriented agriculture in the late 19th century. In order to export goods, infrastructure facilities like railways and industries such as meat processing were necessary. The urban labor force employed in those activities soon organized itself to become a key political actor in the early 20th century (Skidmore et al 1984, 252-258).

²⁰ Chile did not have corporatist or clientelistic forms of control of the popular classes. Its working class had a history of resistance to cooptation and militancy (Teichman 2001, 181).

Many industrial firms emerged between the 1940s and the 1970s backed by state-led industrialization. Some would become business groups that were not related to agriculture, thereby challenging the power of traditional ruling classes (Skidmore et al 1984, 362).

At the beginning of the 1940s, Juan Domingo Perón burst onto the political scene, first as a member of a military government and later as a democratically elected president. His ten years in power and more would change the national political landscape forever. Under his two first administrations (1946-1952 and 1952-1955), ISI policies included the nationalization of foreign firms²¹, state monopoly over exports of agricultural crops, and creation of SOE. The most important ones among the latter were the national gas company *Gas del Estado* and the telecommunications company ENTEL, the steel company SOMISA, the National Airline *Aerolíneas Argentinas*, and the National Railways *Ferrocarriles Argentinos*.

His policies improved the income and working conditions of urban workers, represented a burden for landowners, and failed to generate self-sustaining growth. In a climate of economic stagnation and political confrontation, Perón was overthrown by a military *coup* in September 1955²². This was the beginning of a period of contradictory economic policies and political violence that would last for decades²³ (Skidmore et al 1984, 259-60; 273).

Under the presidency of democratically elected Arturo Frondizi (1958-1962), the state created the SOE *Servicios Eléctricos del Gran Buenos Aires* (SEGBA) in electric energy and

²¹ British, American, and French capital owned the railways, telecommunications, and dock facilities, respectively.

²² The *coup* was backed by the naval army, part of the other forces, and an important part of the civil society. The factors behind it were not only economic, but also political and related to the authoritarianism of his government (Cortes Conde 1998, 65).

²³ It is worth noting that the interruption of democratic rule by military governments began in 1930.

Yacimientos Carboníferos Fiscales (YCF) in the exploitation of coal. Other policies during his administration aimed at developing infrastructure, accelerating industrialization, and stimulating agricultural production oriented towards Latin American markets. The government also promoted foreign investment in sectors such as oil, automobiles, steel, and household appliances. State and foreign funds financed new industrial and infrastructure development. In a new climate of economic and political instability, Frondizi was overthrown by another military *coup*. Under the presidency of democratically elected Arturo Illia (1963-1966), contracts with foreign oil firms were renegotiated, allowing a larger participation of foreign capital in *Yacimientos Petrolíferos Fiscales* (YPF), the SOE operating in the oil sector since 1922 (Skidmore et al 1984, 264-6). In a context of increasing political violence, president Illia was overthrown in 1966 by another military *coup* (Skidmore et al 1984, 264-6).

By 1970, domestic business groups already operated in sectors such as leather goods, textiles, household appliances, electric machinery, metalworking, glass, cement, pulp and paper, aluminium and steel. The *Banco de Crédito Industrial Argentino* was the state agency responsible for financing the industrial sector, but its profile addressed commercial financing of short-term operations such as acquisition of raw materials and salaries. Even if the bank financed several industrial sectors such as food, beverages, textiles, clothing, metalworking, chemicals, and automobiles; SOE and commercial institutions were among its most important borrowers.²⁴

²⁴ The *Banco de Crédito Industrial Argentino* was created in 1944, reformed in 1946, renamed first as *Banco Industrial de la República Argentina* and then as *Banco Nacional de Desarrollo* by 1970. It lost relevance in the 1980s and was finally liquidated in the 1990s (Lopez and Rougier 2012, 17-22).

In 1973, democratically elected president Héctor Cámpora called for elections right after having taken office, bringing an ill Perón back into power²⁵. A year later, his widow and vice-president continued to govern in a context of even greater political strife until the violent military *coup* of 1976.

Although long before the *coup*, the military had already penetrated the state and taken over many SOE, the three armed forces went on to further divide up ministries and enterprises after 1976 (Teichman 2001, 99). The technocratic coalition behind the government included bureaucrats linked to land/business interests and to international financial institutions as well as collaborationist trade union leaders²⁶. Despite the policies implemented aimed at economic stabilization, public deficit reduction, financial and trade liberalization, and privatization (Skidmore et al 1984, 270), they were neither successful nor sustainable. By 1982, the regime was over and its fall was driven by the perpetration of human rights violations, the Falklands/Malvinas war, and the international debt crisis.

Democracy was restored with the presidential election of Raúl Alfonsín in 1983, who had to cope with the difficulties of the democratic transition after the military regime, in harsh economic times. His economic plan included liberalization and privatization once more. Some progress was made with the former, but Congress was opposed to the latter. In the late 1980s, hyperinflation precipitated the end of Alfonsín's administration and accelerated the presidential election of Carlos Menem in 1989. This last event was followed by a second hyperinflation in 1991 (Fracchia et al 2010, 332).

²⁵ His party had been proscribed for a long time.

²⁶ It is worth noting here that the government severely repressed workers (Teichman 2001, 100).

Throughout the 1990s, a comprehensive program pursuing macroeconomic stabilization was implemented and included policies towards trade and financial liberalization as well as an extensive program of privatizations. The motivation behind the latter was the income, in the form of cash or external debt bonds, considered crucial to fiscal health and macroeconomic stabilization.

The largest part of the privatization program consisted in few large vertically integrated natural monopolies in public hands. They included SEGBA, *Agua y Energía Eléctrica*, and HIDRONOR in electric energy, ENTEL in telecommunications, *Obras Sanitarias de la Nación* in water and sewerage, and YPF and *Gas del Estado* in the oil and gas sector. YCF in mining, the national airline *Aerolíneas Argentinas*, the railway company *Ferrocarriles Argentinos*, the steel company SOMISA, companies operating in military defense²⁷, and ports were also privatized (Skidmore et al 1984, 273; Teichman 2001, 111). By 1994, all of them were already in private hands (Galiani et al 2005, 68). After 1995, most provincial public banks were privatized (Galiani et al 2005, 112).

There was no development bank to fund the acquisition of formerly SOE. In fact, the former *Banco Nacional de Desarrollo* (BANADE) itself had been liquidated as part of the reforms throughout the decade. An underdeveloped capital market limited privatization financing. Most funding for privatizations came from foreign sources (Galiani et al 2005, 112).

²⁷ The military resisted the privatization of YPF and of military defense companies (Teichman 2001, 116, 122).

Privatizations were carried out while decision-making power was concentrated in the hands of the president²⁸ and backed by members of multilateral banks, the business sector, and collaborationist labor leaders (Teichman 2001, 97-98, 119). Although some business groups that had benefited from state contracts opposed privatizations at the very beginning due to the risk of losing their benefits, some of them became owners or part of the consortia that purchased SOE (Teichman 2001, 116, 122). However, provision for making contributions mandatory to the private pension system was met with opposition from labor and Congress (Teichman 2001, 122).

The state transferred all the main SOE to domestic business groups and foreigners in virtually whole sectors of the economy such as utilities and non-renewable natural resources, whose collective value was estimated at 4% of GDP (Lora and Panizza 2002, 11). However, the state retained the ownership of 14 public banks, including the largest ones such as *Banco Nación* and *Banco de la Provincia de Buenos Aires* (Galiani et al 2005, 112), as well as a considerable part of the social security system.

Summary

To conclude this introduction to business groups in Brazil, Chile, and Argentina, Table I presents a comparison of privatizations across the three countries in terms of motivation, timing, financing, and scope. In the three cases, the programs had fiscal motivations and included the privatization of SOE in electricity, telecommunications, water and sewerage, steel, transport and infrastructure sectors as well as the main ports. The programs differed in the speed and scope of their implementation, the nationality of the capital they benefited, and the extent of state financing for business.

²⁸ In particular, reform was achieved using executive authority decrees instead of laws.

Table I: Comparison of Privatization Programs in Brazil, Chile, and Argentina, 1980s-1990s

	Brazil		Chile		Argentina	
Motivation	Fiscal		Fiscal Capital Market Development		Fiscal	
Timing	Gradual		Successive rounds		Fast-track	
State Financing	YES Loans Equity (BNDES & Public Pension Funds)		YES Loans (1 st round) Equity (Private Pension Funds)		NO	
	Brazil		Chile		Argentina	
Sectors	Privatized	State Owned	Privatized	State Owned	Privatized	State Owned
Utilities						
Electric Energy	X	X	FC		FC	
Telecommunications	FC		FC		FC	
Water & Sewerage	X		FC	X	FC	
Natural Resources						
Oil & Gas		X		X	FC	
Mining	X	X		X	X	
Transport & Infrastructure						
Airline	X		X		FC	
Railways	X		X	X	X	
Ports	X	X	X	X	FC	
Banking	X	X	FC	X	FC	X
Social Security		X	X		X	X
Other						
Steel	X	X	X		X	
Petrochemical	X		X		X	

Source: Author.

Note: FC means that the participation of foreign capital in the privatizations of the sector was substantial.

In Brazil, the privatization program was implemented gradually over a decade. It included firms owned by the federal and state governments, but it was selective in terms of the sectors included. As recorded in Table I, the state retained important parts of the electric energy, oil, and mining sectors as well as ports and the most important banks. Foreign capital participation concentrated on telecommunications. The funding from BNDES was crucial to make the participation of domestic business groups in privatization bids successful. The BNDES itself as well as some public pension funds held equity in privatized firms in sectors considered a priority, such as mining.

In Chile, privatizations were carried out in three successive rounds, but most of them took place during the military dictatorship. Their scope was broad including infrastructure and social services. However, the state retained the exploitation of copper and oil, as shown in Table I. Not only domestic business groups participated in privatizations. Many former SOE went to foreign capital, particularly in utilities and banking. All the rounds included some form of state support for financing, such as loans from public banks, the development of the capital market, and the authorization to private pension funds to hold shares of privatized firms.

In Argentina, the privatizations were implemented over four years. The program included all main SOE in all sectors of the economy with the exception of banking and social security. Only some provincial public banks were privatized and an important part of the social security system remained public. In addition to domestic business groups, foreign capital was a major participant in the privatizations of SOE operating in the utilities, oil and gas, transport, infrastructure, and banking sectors, as shown in Table I. No formal system or institution inside the program granted financing to interested firms.

Although beyond the scope of this dissertation and before turning to its core, it is worth mentioning that the critical changes that took place over the 1980s and 1990s produced significant transformations of the social structure in terms of higher inequality, poverty, and violence in the three countries under study.²⁹

²⁹ The literature on the social consequences of market oriented reforms in Latin America is abundant. A relatively recent look has been offered by Kingstone (2010).

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**Essay 1. Public Policies towards Business in Brazil, Chile, and Argentina:
Investor Protection and Business Groups, 1990-2003**

1. Introduction

In the United States and United Kingdom, the larger corporate sector is dominated by free standing and widely held firms wherein ownership is shared by many shareholders and control is in the hands of managers. Elsewhere in the world, the larger corporate sector is substantially run by business groups wherein few shareholders own large blocks of shares and control decisions.

Business groups are often structured in the form of a pyramid where the controlling shareholder dominates from the apex. This is usually a wealthy family. Pyramids, cross shareholding among affiliate firms, and special voting right shares allow wealthy families to concentrate on a country's large corporate sector decisions without making any commensurate capital investment (Morck et al 2005).

A significant part of the literature on corporate governance supports the thesis that free standing and widely-held firms are more prevalent in countries where investors have better legal protection against pilfering by insiders. Small investors hold common shares in numbers sufficient to render most large firms widely-held where they feel protected against such abuses. Weak legal rights for small investors make them less interested in holding shares. Business groups where blocks of shares and control are concentrated among fewer hands are more prevalent in countries with lower levels of legal and regulatory protection for public shareholders (La Porta et al 1999; Burkart et al 2002; Khanna and Yafeh 2007). This same literature has reported that investor protection is amongst the weakest in the world (Chong and Lopez de Silanes 2007) in Latin America and family controlled business groups have been predominant and underperforming in the region compared to Asia (Colpan et al 2010).

In this study, I will analyze whether the evolution of investor protection can explain the evolution of business groups in three different countries of South America: Brazil, Chile, and Argentina during 1990 and 2003. I challenge this perspective by proving how changes in investor protection over this period do not appear to have had much if any effect on the evolution of business groups in Brazil, Chile, and Argentina.

This research does not ignore the fact that most business groups in these three countries were both born and backed by state-led policies that granted them preferential access to factors of production and markets (Colpan et al 2010) during both military and democratic governments. Indeed, this study acknowledges that business groups were created in the context of limited contract enforcement under certain legal systems (Kali 1999), imperfect property rights (Maurer and Sharma 2001), and imperfect information as to capital markets (Ghatak and Kali 2001; Kali 2003).

The results of this work compare to what Morck et al (2007) noticed about business in Canada. Despite the prevalence of freestanding and widely held firms, business groups were also important in Canada. Morck et al studied investor protection in the Canadian corporate sector over the last century to understand the evolution of free standing and widely held firms along with business groups. Investor protection only became strong after the 1960's (Armstrong 1986; 1997; Boothman 2000). These same authors also found that freestanding widely held firms became more common as the century progressed towards the mid-60s. However, they became steadily rare thereafter, which accounts for a diminishing fraction of corporate assets. Conversely, family controlled pyramids were commonplace at the beginning of the century. They receded markedly by mid-century and then reappeared at the end of the century. Therefore, the standard corporate governance thesis does not apply

here. The evolution of investor protection does not explain the evolution of the corporate sector in Canada over the twentieth century.

The Canadian experience provides a useful contrast to the investigation of business groups in South America at the turn of the twentieth and twenty-first centuries. In the three cases under study, business groups were both present and important throughout the twentieth century. Between 1990 and 2003 business groups experienced a variety of market-oriented reforms and institutional changes, including those affecting investor protection rights. Access to information was easier and data more reliable because the three countries were under democratic rule. The study ends in 2003 because institutional events, namely Argentina's default, have affected similarities and differences between the three countries since then.

This study compares previous research about business groups and investor protection in these three countries in order to identify a pattern of evolution between investor protection and business groups specific to each case. It studies the evolution of investor protection across Brazil, Chile, and Argentina between 1990 and 2003 through the analysis of law reforms, law enforcement, and corporate rules affecting investor protection in each country. It backs it with statistical evidence based on a sample of their most important business groups. It analyzes evolution patterns of investor protection and business groups both in each country and across the three of them. The methodological approach consists in comparing three case studies where we analyze a sample of the most important business groups of each country. This study provides new evidence that contradicts the negative relation between the evolution of investor protection and business groups' performance.

The paper is structured in five main sections. The following one presents a review of the literature on business groups from the perspective of corporate governance. The third

section describes and compares the patterns of evolution of investor protection across the three countries. The fourth section describes and compares the patterns of evolution of business groups across the same countries. The fifth section explains why investor protection does not explain the differences in the evolution of business groups across these three countries. The last section provides the conclusion.

2. Corporate Finance and Business Groups: A Brief Literature Review

Business groups have been analyzed from many different perspectives. Some studies in political economy emphasize their developmental role as part of industrialization policies led by the State (Rosenstein-Rodan 1943; Gerschenkron 1962; Evans 1995; Waldner 1999; Woo-Cumings 1999; Kohli 2004). Due to their proximity with the State, scholars have more recently studied their rent seeking activities and ‘crony capitalism’ (Krueger 1974; Bhagwati 1982). Industrial organization and business studies have explained the economic diversification of business groups as a response to market imperfections (Khanna and Palepu 1997) and internal capabilities (Amsden and Hikino 1994).

Sociologists have been interested in business groups as networks. They have revealed how their noneconomic functions are guided by cultural/institutional goals (Granovetter 2005) as well as their sense of “responsive community” around common values (Etzioni 1998). Other scholars have studied the link between business group structure, political groups and public policies (Gourevitch and Shinn 2005). Meanwhile, studies on corporate finance have focused primarily on their pyramidal structure and the conflict between controlling and minority shareholders (La Porta et. al. 1997; Morck et. al. 2005; Khanna and Yafeh 2007). Still others (Morck et al 2005) have argued that business groups lead to ‘economic

entrenchment' and distortion of property right protection and capital markets derived from political influence in public policy³⁰.

However, the prevalent way of organizing big business in the United States and United Kingdom remains free standing and widely held firms. Their ownership is shared by many shareholders and control is in the hands of managers. This type of corporation represents above 80% of big business in the United States and above 90% in the United Kingdom (Morck et al 2005, 660-2). The conflict of interest between owners and managers lies at the very center of this corporate organization. This largely motivated the development of the principal-agent theory (Jensen and Meckling 1976; Strausz 1997).

Business groups are the other way of organizing big business around the world, wherein few shareholders own large blocks of shares and control corporate decisions (Morck et al 2005).

Even if large block-holders occur in the United States, they are smaller and much less common than in most other countries. Block holders seldom control more than one corporation and 'family firms' often refer to small business. Some scholars (Hawley 1966; Morck 2010) argue that public policies in the United States and United Kingdom are the reason for this outcome. American business groups were mostly eliminated through policies that raised inter-corporate taxation of dividends in the 1930s³¹. British business groups

³⁰ See Morck et al (2005) for a further discussion.

³¹ "The power of business groups was threatened and reduced to the benefit of minority shareholders from the Sherman Antitrust Act of 1890 to the creation of the US Securities and Exchange Commission and the Glass-Steagall Act, which separated commercial and investment banking, in the mid-1930s, to the collapse of pension funds in the 1960s that spurred employee protection in the 1970s, and to the Democrat-led attack on the tax deductibility of pension contributions by firms with the Tax Equity and Fiscal Responsibility Act of 1982". Recently, the Sarbanes- Oxley Act of 2002 provided more stringent evaluation and disclosure requirements on public companies, including prohibitions on inside trade during pension fund 'blackout' periods. Well-known cases of American business groups were Rockefeller and Carnegie (Seabrooke 2007).

practically disappeared in 1968 with the takeover rule and mandate for shareholders to buy the entire stock and acquire 30% of the shares of any listed company. Political coalitions under extraordinary circumstances allowed for the application of these constraints to concentrated capital in both places.

In most other countries, a large proportion of the controlling shareholders in big business were usually extremely wealthy families. Business groups were prominent in developed countries and represented over 65% of big business in Ireland, 55% in Sweden, 50% in Belgium, 45% in New Zealand, 35% in Denmark, 30% in Canada, 25% in Norway and Spain, and 20% in France, Italy and the Netherlands (Morck et al 2005, 662). In developing countries, legal and regulatory protection for public shareholders was weaker. Big business often had controlling shareholders that represented wealthy families or the State (Morck et al 2005, 661) and the firms affiliated to these business groups tended to be relatively large and economically important (Khanna and Yafeh 2007, 332). Therefore, business groups were even more prominent in the context of developing countries and represented 100% in Mexico, over 70% in Indonesia, over 65% in Malaysia, and over 60% in Thailand (Morck et al 2005, 662).

In reference to the definition provided by Khanna & Yafeh (2007, 331), we consider a business group to be a set of legally independent firms usually operating in diversified sectors and organized like a pyramid, with a controlling shareholder at the apex.³² This

³² The structure of a business group tends to be either a pyramid or a network. Pyramids prevail in Western Europe, South East Asia, and Latin America. Business groups structured as networks form a constellation of legally independent companies that cooperate for common long-term goals. Their main characteristic is that they are loose coalitions of companies without legal status and where no single firm or individual exercises the dominant control over strategic and budgetary decision-making for the entire group. Some examples: The Japanese Mitsubishi group, Silicon Valley, and the Third Italy (Colpan and Hikino 2010, 19). For studies on this type of business groups, see Powell (1990); Gerlach (1992); Gulati (1995); Smith-Doerr and Powell (1995); Podolny and Page (1998); Lincoln and Gerlach (2004), and Child et al (2005).

particular shareholder is usually a wealthy family that controls all the firms of a group whose collective value is far beyond its own wealth.³³

In order to understand how this extended control is possible, please consider figure 1.1. The controlling shareholder owns a minimum of 51% of the voting shares of the firms in the first upper tier of the pyramid. Each first tier firm owns a minimum of 51% of the voting shares of the firms in the following tier, which also owns a minimum of 51% of the voting shares of those in the following tier, and so on.

In addition to equity ties among firms, the controlling shareholder may choose the people entitled to strategic positions from its family or social circle, for all the group's firms. Accordingly, equity and social ties among firms let the controlling shareholder control not only one large firm but many firms that are collectively worth substantially more than its own wealth (Morck et al 2005, 659, 663).

Why is this pyramid so interesting? If a controlling shareholder wants to operate its business at a larger scale, additional funds are needed, and they are beyond its own capital. Obtaining additional funds generally implies that the controlling shareholder of any firm may risk losing control of the business. If the firm is financed through equity, the control of the business is diluted among more shareholders. If the firm is financed through debt, the company has a higher bankruptcy risk. Both strategies of business expansion increase the risk of the controlling shareholder losing control.

³³ On pyramidal business groups and families, see Almeida and Wolfenzon (2006).

Figure 1.1: A Simplified Control Pyramid

Source: Author based on Morck et al (2005)

A pyramidal business group is a better alternative because it allows the controlling shareholder to lower bankruptcy risk by financing with equity from outside investors while securing control of the business (Morck et al 2005, 674). In other words, corporate finance determines corporate governance and those who provide funds in the form of equity have legal power over ordinary and extraordinary corporate decisions. However, a pyramid is an

organizational arrangement that successfully extracts control power from (many of) those who own the firm³⁴.

As a consequence, the controlling shareholder can lift assets and income from lower to higher tier firms and drop liabilities and losses from higher to lower tier firms. This is called ‘tunnelling’ or investor expropriation (Morck et al 2005, 664; Chong and Lopez de Silanes 2007, xvii).³⁵ As mentioned, the conflict between the controlling shareholder and other investors exists at the core of a pyramidal business group (Shleifer and Vishny 1997; La Porta et al 1999, 16).

Tunnelling can take on a variety of forms. In some countries, insiders may simply steal the profits. In others, insiders may sell the output or the assets of the firm they control. They are financed by outside investors and can sell them to another entity they own, at below market prices. These operations, though often legal, usually resemble theft. In other cases, however, legal expropriation can take on the form of overpaying executives. The phenomenon of tunnelling may be reflected through the concentration of corporate ownership, the large spread between control and cash rights, pyramids, and low dividend payments (Lopez de Silanes et al 2002).

According to Chong and Lopez de Silanes, “billions of dollars-worth of wealth are siphoned away from outside investors to controlling shareholders and their private company allies. This expropriation prevents investors from devoting funds to the corporate sector, which leads to low evaluation of corporate assets, stunted capital markets, and slower economic growth” (2007, xvii).

³⁴ Pyramids are the most common way of separating ownership from control (Morck et al 2005).

³⁵ For case studies on tunneling, see Johnson et al (2000).

It is worth asking why investors deposit their money where their investment is likely to be expropriated. Among possible answers, Khanna and Yafeh prefer that of group reputation³⁶ and returns on some core asset³⁷. They argue that “group reputation for risk sharing” and assistance to poor performing companies reduces the default risk of firms belonging to business groups. This is an attractive feature for investors, even if they are exposed to the risk of expropriation (2007, 589).

They also argue that “at least some part of alleged tunnelling may in fact represent returns on a core asset” that can be “a socially productive one, such as some core entrepreneurial ability, or socially detrimental lobbying potential” (2007, 589). In other words, certain companies would have a more predictable and higher performance because they possess an asset that is not accessible to other companies. This asset may be a unique entrepreneurial ability or a unique rent-seeking connection. In return for more predictable and greater performance, investors would accept to be ‘billed’ through tunnelling.

At this point, it is interesting to ask about the welfare consequences of business groups. While considering this aspect, it is not clear what alternative business groups should be assessed against. It is worth mentioning here that some scholars in corporate finance consider ‘the ideal’ to be a well-functioning market economy (Khanna and Yafeh 2007, 365). As the real world is distant from ‘the ideal’, it is valid to ask what the organizational form would be without business groups, and how market-supporting institutions could spontaneously emerge.

³⁶ “In the early twentieth century tunneling did not seem to be a major concern for British investors”. They were “eager to invest money in multinational trading groups with certain pyramidal characteristics; affiliation with one of the family-controlled British merchant houses was apparently viewed as a stamp of certification, rather than as a reason for fear of expropriation” (Jones 2000, ch.6 cited in Khanna and Yafeh 2007, 589).

³⁷ The literature also mentions the lack of knowledge of ‘naïve’ investors and the lack of or small number of feasible investment alternatives available. Khanna and Yafeh do not find these explanations plausible.

Within this debate, some scholars tend to argue that business groups are often ‘paragons’ that provide alternative solutions to institutionally weak economies. Some authors (Maksimovic and Phillips 2002) suggest that business groups are an efficient balance between certain business opportunities where the appropriate counterfactual is not necessarily stand-alone firms but some other corporate form. For example, Maurer and Haber (2007) observe that when restrictions were imposed on related lending between Mexican business groups in the late 1990s, they led to the decline of the credit market rather than to the emergence of more competitive credit where all firms could access credit equally. Pyramidal business groups may have important positive effects in economies with underdeveloped factor markets and institutions (Morck et al 2005, 669).

Other authors (Khanna and Yafeh 2007, 365-6) point out that the relevant counter system to business groups can change with economic development. According to them, a plausible feasible alternative may be underdevelopment and limited market institutions in the absence of business groups in early stages of development. Conversely, superior capital, labor, and other market institutions can develop in the absence of business groups in more advanced economies³⁸.

Other scholars claim that business groups are ‘parasites’ taking advantage of their opportunities under conditions of weak investor protection. Several studies deal with corporate governance in business groups and its relation to the financial crisis in East Asia (Corsetti, Pesenti and Roubini 1999; Johnson, Boone, Breach, and Friedmand, 2000; Kim and Lee 2003). In the same line of thought, some authors (Charumilind, Kali, and

³⁸ Yet, according to the authors, this conjecture has never been tested.

Wiwattanakatnag 2006) argue that crony capitalism enabled business groups to borrow easily and moral hazard problems associated with this could have precipitated the crisis.

Some scholars (Khanna and Yafeh 2007, 366) ask whether economies dominated by business groups are more crisis-prone than economies characterized by stand-alone companies. They acknowledge that links between group firms may propagate adverse shocks, but mutual insurance within groups can sometimes dampen them³⁹. They wonder about the extent to which a few families controlling a large fraction of an economy could run into macroeconomic problems through business groups, microeconomic governance or management difficulties. To this question, some authors (Morck et al 2005, 688) argue that, excluding state owned enterprises, the large corporate sectors of most countries are predominantly controlled by a few very wealthy families. Individual families use pyramids to control considerable or predominant slices of the country's market capitalization. Furthermore, poor governance may potentially be magnified by a few family patriarchs in terms of inefficient and economy-wide capital allocation, reduced investment in innovation, and retarded economic growth. Such elite families appear to influence public policies into curtailing the development of private property rights and capital market, along with economic openness. These same authors (Morck et al 2005, 711-714) call this phenomenon 'economic entrenchment'.⁴⁰

³⁹ Yet, they point out that on theoretical grounds, this affirmation is uncertain (Khanna and Yafeh 2007, 366).

⁴⁰ "Family control pyramids allow the simultaneous presence of divergence of interests agency problems (Jensen and Meckling 1976) and entrenchment agency problems (Stulz 1988). This means family control pyramids are potentially subject to worse agency problems than freestanding firms. Lower tier firms in family control pyramids potentially suffer from both problems simultaneously. The controlling owner of pyramids can easily have cash flow rights as small as those of the professional managers of widely held firms, while exercising voting rights sufficient to deter any control challenge, thereby entrenching their control. While divergence of interest and entrenchment problems are well understood in the corporate finance literature, pyramids potentially aggravate agency problems by conferring both on their lower tier firms simultaneously" (Morck et al 2005, 685-6).

There is extensive literature that links corporate governance forms with legal, regulatory, and institutional environments. La Porta et al (1997; 1998; 1999) argue that freestanding and widely held firms tend to be more common in countries with good legal protection of minority shareholders. Often controlling shareholders are less afraid of being expropriated in rich common law countries if they lose control, through a takeover for example. Accordingly, they tend to opt out of their ownership of voting rights by selling shares to raise funds or for the sake of diversification (La Porta et al 1999, 473).

In contrast, in countries with poor legal protection of minority shareholders, losing control involuntarily and becoming a minority shareholder may be too costly in terms of giving up the private benefits of control. This explains why these shareholders hold more voting rights and have less interest in selling shares on the market. Securing themselves from expropriation, controlling shareholders take advantage of poor legal protection for outside investors. As Wolfenzhon (1998) pointed out, pyramids can be used by controlling shareholders to make existing shareholders pay the costs, but not share in all the benefits of new ventures (La Porta et al 1999, 500). This may explain the superior performance of business groups under weak investor protection.⁴¹

These scholars have cultivated the standard corporate governance thesis according to which good shareholder protection goes together with dispersion of ownership (La Porta et al 1999, 496). Conversely, weak investor protection goes together with concentration of ownership. In such contexts, control over firms tends to be concentrated in the hands of

⁴¹ Others authors (Burkart, Panunzi, Shleifer 2002) have further this research from the perspective of ownership concentration and management control in family firms. They argue that when legal regimes successfully limit the expropriation of minority shareholders, the widely held professionally managed corporation emerges as the optimum outcome. In legal regimes with intermediate protection, even if management is delegated to professional managers, the family stays on as large shareholders to monitor them. Yet, in legal regimes with the weakest protection, the founder's ability to control expropriation is too limited, and management stays with his family even when someone else can run the firm better (2002, 4).

wealthy families or the State (La Porta et al 1999, 473), pyramidal business groups prevail, the conflict between controlling shareholders and investors is worse and the problems of ‘tunnelling’ are more severe. This thesis is backed by significant empirical evidence (La Porta et al 1999, 15, 147; Burkart et al 2002; Khanna and Yafeh 2007, 347; Morck 2007, 120; Chong and Lopez de Silanes 2007, xvii).⁴²

Following this perspective, Morck, Percy, Tian and Yeung (2007) studied the evolution of the corporate sector in Canada throughout the twentieth century, where both free standing and widely held firms and business groups were commonplace.⁴³ The Canadian case can shed light on the study of investor protection policies in South America and their impact on the evolution of business groups. Investor protection became stronger in Canada in the mid-twentieth century. Policies to improve investor protection were implemented in Brazil, Chile, and Argentina at the turn of the twentieth and twentieth first centuries.

These authors observe that at the beginning of the twentieth century, large pyramidal corporate groups dominated Canada’s large corporate sector and were controlled by wealthy families or individuals, as in modern continental European countries. By the mid-twentieth century, the large Canadian corporate sector was primarily made up of freestanding widely held firms as in modern large corporate sectors of the United States and United Kingdom. In the 1960s, 80 percent of corporate sector assets corresponded to large widely held freestanding firms (Morck et al 2007, 67). Yet, in the last third of the twentieth century, there was a decline in the importance of freestanding widely held firms and a commensurate rise in the prevalence of family pyramidal groups (Morck et al 2007, 101).

⁴² On the paradox of business groups in developed countries, see Morck (2010).

⁴³ It is worth noting that despite the presence of business groups, “no single family controls a predominant slice of the Canadian economy” (Morck et al 2005, 667).

Recalling that widely held firms should have become more commonplace as shareholder legal rights grew stronger (La Porta et al 1999; Burkart, Panunzi, and Shleifer 2002), the authors wonder if shareholder rights in Canada grew stronger through the first half of the century and then were somehow eroded.

Morck et al (2007, 120) mention that corporate governance laws in Canada were extraordinarily weak at the beginning of the twentieth century. In 1906, a Royal Commission on Life Insurance revealed tunnelling in the Mackenzie-Cox pyramid. Money flowed from insurance firms to power firms. Inside trade of each other's stocks was also exposed in pyramid firms. Four years later, this investigation resulted in a law for insurance firms to tighten investments and tighten rules. Indeed, corporate governance was basically a matter of reputation. It was constrained by vague and contradictory statutes at the provincial level and demonstrated common law precedents.

In 1910, the first federal corporation law was enacted. It required firms to hold general meetings every two years⁴⁴ and mandated managers and directors to offer shareholders neither minority shareholder rights nor fiduciary duties. Under common law, the former had a duty to the firm, which was interpreted as trumping any duty to shareholders. Shareholders had no rights to inspect books unless they could convince a judge of a precise legal objective and identify the specific records containing the information. Moreover, auditors had no duty to inform shareholders of misconduct. One precedent held that auditors were justified in believing servants the firm trusted. Another precedent warned that an auditor who contradicted governance did so at his own risk and could be held liable (Morck et al 2007, 120-121).

⁴⁴ "Only Ontario required annual shareholders' meetings" (Morck et al 2007, 120).

Despite scant protection for shareholders, stock holdings grew rapidly over the 1920s. A.E. Ames and CO., Dominion Securities, Royal Securities, Nesbitt, Thompson and Wood Gundy underwrote a boom of new issues. Solloway, Mills and Co., McDougall and Cowans, Greenshields and Co, and Watson and Chambers also became major players in the investment business. After the crash in 1929, the Financial Post disclosed information about the industry. As the government struggled with huge foreign debt⁴⁵ and growing trade deficit, Solloway was jailed (Morck et al 2007, 120-121).

After the abuse discovered under the 1929 crash, the United States expanded its public shareholder rights and established the Commission of Securities and Exchange. At that time, the Prime Minister of Canada was Liberal Mackenzie King. His senior cabinet minister, C.D. Howe, opposed such regulations. Moreover, stock market regulation in Canada was under provincial jurisdiction and provincial securities commissions had been established in the 1930s. However, trading on insider information was legal and disclosure was minimal. Provincial authorities criticized securities regulations as undue Americanization. Indeed, Canada stock markets in the 1950s resembled the New York Stock Exchange in the 1920s (Morck et al 2007, 121-122).

Small investors in the U.S. had responded massively to telephone calls from Canadian ‘boiler-rooms’⁴⁶, who were offering them resources in oil and minerals north of the 49th parallel. Some of them found themselves owners of worthless moose pasture. The unlucky ones had all bought the same patch. U.S. Congressmen demanded that the Canadian Federal Government to do something, but these regulations were beyond its jurisdiction. Then the

⁴⁵ Run up by the Canadian National Railway (Morck et al 2007, 120).

⁴⁶ In this context, ‘boiler room’ refers to a call center selling questionable investments by telephone.

United States threatened to put an embargo on investments in Canada unless the Toronto market was verified. Finally, the Ontario government established the Ontario Securities Commission, mandated standardized disclosure and limits to insider trading in the mid-1960s (Morck et al 2007, 122).

The Canadian Business Corporations Act strengthened shareholder rights in 1985. It included an Oppression Remedy that allowed small shareholders to sue large shareholders.⁴⁷ This became small shareholders' main weapon against corporate insiders. Various exchange and securities commission reforms further expanded shareholder rights throughout the 1990s (Morck et al 2007, 122).⁴⁸

Morck et al (2007, 122) found that shareholder rights had been consistently weak up to the 1960s while diffuse ownership had inexorably expanded. Since then, shareholder rights have been strengthened while widely held firms have begun to fade away. Morck et al (2007,10) pointed out that family controlled pyramidal groups followed the opposite pattern. They were commonplace at the beginning of the century, receded markedly by mid-century, and re-appeared in the last third of the century. The change in shareholder rights offers a poor explanation as to the rise and fall of the widely held firms compared to that of business groups in Canada over the last century (Morck et al 2007, 122).⁴⁹

⁴⁷ In corporate law in Commonwealth countries, an oppression remedy is a statutory right available to oppressed shareholders. It empowers these shareholders to bring an action against the corporation in which they own shares when the conduct of the company has an effect that is oppressive, unfairly prejudicial, or unfairly disregards the interests of a shareholder. "In many ways, oppression lawsuits are superior to shareholders' derivative actions because the former target the ultimate controlling shareholder, not just his or her professional manager" (Morck et al 2007, 122).

⁴⁸ "Although solid by international standards, Canadian securities laws are probably still substantially weaker than in the United States. For example, small block holdings, executive pay, research and development and several other critical items need not be disclosed in the same detail as in the United States" (Morck et al 2007, 122).

⁴⁹ According to Morck et al (2007), changes in policies in the latter decades of the century encouraged vast corporate investments in political influence (...) Family-controlled corporate groups are more effective political

In summary, the large corporate sector in the United States and United Kingdom is dominated by free standing and widely held firms where ownership is divided among many shareholders and control is in the hands of managers. The other ubiquitous way of organizing big business around the world is with the business group where few shareholders own large blocks of shares and control corporate decisions. Free standing and widely held firms are more prevalent where investors are better protected. When less legal protection is provided for public shareholders, business groups prevail due to their capacity to expropriate dividends from investors. Both freestanding widely held firms and business groups are typical in Canada. Investor protection improved steadily in the country over the last third of the twentieth century, but this improvement cannot explain the fall of widely held firms along with the rise of business groups over the same period.

This study on Canada is an interesting foil as per my discussion on South America. In the following pages, I will ask if the evolution of investor protection can explain the evolution of business groups in Brazil, Chile, and Argentina at the turn of the twentieth and the twentieth first centuries. Although I agree that business groups are more prominent under poor investor protection, I will proceed to demonstrate how changes in investor protection cannot explain the evolution of business groups in these South American countries between 1990 and 2003.

3. Investor Protection in Brazil, Chile, and Argentina between 1990 and 2003

The crucial failure of corporate governance resides in the expropriation of outside investors by those who are in control of firms (Chong and Lopez de Silanes 2007, xvii). An appropriate legal system provides mechanisms to counter the problem of expropriation

rent seekers than freestanding widely held firms (2007, 136).

through the protection of investor rights such as voting rights for minority shareholders.⁵⁰ Voting rights such as election of board members and decisions in general meetings are key features of equity. These rights allow outside investors to express a voice concerning decisions that ultimately may influence dividends. Without these rights, equity would consist in worthless assets.⁵¹ The main instruments for protecting investors are corporate securities⁵² and bankruptcy laws, as well as stock exchange and government regulations. Legal systems also influence other corporate governance related issues, such as the spread of good governance codes (Djankov, McLiesh, and Shleifer 2004; Aguilera and Cuervo-Cazurra 2004), corporate self-regulations and accounting standards. Equally important is legal enforcement by courts, regulators, and market participants (Chong and Lopez de Silanes 2007, 8).

In this section, I will study the evolution of investor protection between 1990 and 2003 in Brazil, Chile, and Argentina. These three developing countries belong to a geographical zone where investor protection is among the weakest in the world. In order to seize this evolution, I will examine corporate and securities laws as well as adoption of codes of better corporate governance practices and self-commitment regulations in each of these three countries between 1990 and 2003. Following the literature on the subject, (La Porta et al 1998; 1999; Djankov et al 2006; Chong and Lopez de Silanes 2007), I will analyze the evolution of some specific minority shareholder rights, such as one-share one-vote; proxy by email; shares not blocked; cumulative or proportional representation; capital to call a

⁵⁰ And liquidation rights for creditors.

⁵¹ Similarly, without liquidation rights allowing creditors to punish debtors who default on their obligations, creditors would lend no money.

⁵² Securities laws aim at regulating the behavior of market participants and providing incentives for issuers not to abuse their information advantages over investors. These objectives can be attained by higher market supervision, higher standards of information disclosure, etc.

meeting; pre-emptive rights; and oppressed minorities remedies. All of them have been defined in Appendix 1.1. Appendix 1.2. presents a summary on the evolution of these main indicators for each country in 1995, 2000, and 2005⁵³. Additionally, I present the OECD corporate governance principles concerning rights and equal treatment to shareholders in Appendix 1.3. I also present information about the capabilities of specialized agencies in charge of the enforcement of laws and regulations affecting investor protection.⁵⁴

In the following pages, I will show that legal protection for minority shareholders between 1990 and 2003 improved in Brazil and Chile, but deteriorated in Argentina over the same period.

3.1. The Evolution of Investor Protection in Brazil

Most Brazilian business groups are family-controlled. Their voting shares are seldom traded on the stock market. The five largest shareholders in Brazilian business groups concentrate around 89% of voting rights, exercising majority control over business (See Appendix 1.2). As a result, they have significant influence over boards either directly or through appointees. They can control their business groups even further by means of pyramids (Leal and Carvalhal de Silvia 2007, 277). This important concentration of control is facilitated by the fact that listed firms are authorized to have up to two-thirds of non-voting shares as part of their equity capital (see Appendix 1.2). In fact, 87% of Brazilian firms issue non-voting shares. Thus, minority and non-voting shareholders have limited power. Their

⁵³ Comparable information was available for 2005 instead of for 2003.

⁵⁴ I acknowledge that investor protection is influenced by a broader environment in which the rule of law, the regulatory quality, and corruption control are key issues. However, for the purpose of this work, I concentrate on a narrower dimension of law enforcement.

risk of being expropriated by controlling shareholders in Brazil is high (Aguilera 2009, 167-168).

Important steps towards more protection for investors were made with the reforms of corporate and securities laws in 2001 as well as with a subsequent enabling legislation (World Bank 2005, 1; Chong and Lopez de Silanes 2007, 17).

The 1997 Privatization Law had given controlling shareholder rights to sell their shares at the highest bid, without any obligation towards minority shareholders on behalf of acquirers. In more technical words, tag-along rights had been eliminated for the purpose of privatization. Legal reforms in 2001 reinstituted the contractual obligation of tag-along rights by which minority voting shareholders had the right to sell their stakes if majority shareholders sold theirs (Aldrichi and Postali 2010, 362).

Also since 2001, firms that go public have seen the number of non-voting shares they are allowed reduced from 2/3 of their equity capital to one half (Leal and Carvalhal de Silva 2007, 277). Despite this improvement, non-voting shareholders remained unprotected, which allowed companies to exclude them from important benefits, including those that could happen during changes in corporate control⁵⁵ (World Bank 2005, 1-2).

Pension funds, especially related to ongoing or former state-owned companies, became an increasingly important institutional form of investment in the early 1990s (Aldrichi and Postali 2010, 368).⁵⁶ They played a monitoring role in the governance of corporations, by voting at the Annual General Meetings or by nominating members to the board of directors or to the statutory auditor board. Indeed, the auditor board was by law the

⁵⁵ This happened in the merger between AMBEV and INTERBREW. Minority voting shareholders received the 80% tag along while the majority non-voting shareholders were excluded from the deal.

⁵⁶ They account for 25 percent of the free float (World Bank 2005, 2-3).

one mechanism opened to minority shareholders that allowed them to oversee the management and the board (World Bank 2005, 4-5).

However, in order for Congress to approve corporate and securities law reforms in 1997, 1999, and 2001, some important elements of corporate governance reform were watered down (World Bank 2005, 1-2). Apart from the limitations that subsisted relating to non-voting shares and their impact on minority shareholder rights, limitations concerning disclosure rules persisted. Approval and disclosure processes were vague. No explicit requirements were necessary for the board to approve related party transactions.⁵⁷ Issuers of shares had no obligation to provide cash flow statements. In general, accounting and auditing standards remained less detailed than international standards. Other disadvantages for minority shareholders included the fact that boards were not open to independent directors and audit committees were not mandatory. As a result, insufficient oversight persisted regarding insider conflicts of interest (World Bank 2005, 2-4).

Because of these limitations, the Sao Paulo Stock Exchange (BOVESPA) created a mechanism of voluntary adhesion to good corporate governance practices in December 2000. It launched three new listing segments, wherein firms committed to higher governance standards by means of a contract. This innovation provided firms with a self-selection mechanism for governance certification. To be listed in Level 1, companies had to provide higher standards of disclosure than those legally mandated and maintain a minimum free-float⁵⁸ of 25 percent of the firm's capital. Level 2 required that companies comply with even

⁵⁷ A transaction between the company and a director, manager or controller, directly or indirectly, is deemed a related party transaction. This may include loans to directors and consulting contracts.

⁵⁸ Free float is generally described as all shares held by investors, other than restricted shares held by company insiders. It does not include restricted shares, which are owned by company management, officers and other various insiders because it's assumed that those shares are being held on a very long-term basis.

tougher rules regarding disclosure, financial reports, audit committees in the boards of directors, and minority shareholder rights. Firms listed in the following listing segment called Novo Mercado were required to issue only voting shares⁵⁹ (Aldrichi and Postali 2010, 363). The contractual relationship between BOVESPA and the firms listed in the new segments stipulated enforcement mechanisms, such as fines. Firms listed on Level 2 and on Novo Mercado committed to submit any shareholder dispute to arbitration, which constituted an alternative to judicial procedures (World Bank 2005, 5).

In addition to that, the Brazilian Corporate Governance Institute (IBGC) also worked to improve corporate governance among listed and unlisted firms since the mid-1990s. It worked with issuers, investors, directors, management and other market participants in order to issue a Code of Best Practices (World Bank 2005, 5; Aguilera 2009, 160).

Finally, the *Comissão de Valores Mobiliários* (CVM) gave minority investors the authority to investigate corporate actions perceived as harmful. Since the 2001 legal reforms, the CVM has made improvements in terms of oversight, investigations, and enforcement of regulations (World Bank 2005, 1-2).

Regarding the evolution of specific minority shareholder rights, Appendix 1.2 shows some key indicators. All minority shareholders were protected with the legal right to receive at least 25% of their dividends over the period studied. Other shareholder rights also remained unchanged over the period. These rights consisted in the possibility of accumulating votes for one candidate to run for election to the board; having their interests proportionally represented on the board; calling for an extraordinary shareholder meeting with a minimum requirement of 5% of capital; and participating in some of the governance

⁵⁹ None of the three higher BOVESPA listing segments required independent directors (World Bank 2005, 4-5).

bodies. Other shareholder rights were introduced after 2000. These consisted in the possibility to vote by mail; to have the first opportunity to buy new issues of stock; and to challenge the decisions made on fundamental issues by the management or the assembly, either through judicial venue or by requiring the purchase of their shares. One particular shareholder right that was eliminated after 2000 was the right to have shares blocked prior to a shareholder meeting. The elimination of this right prevented shareholders from selling their holdings before a meeting (Chong and Lopez de Silanes 2007, 7-9; 16-21).

In summary, Brazil made improvements in terms of investor protection over the period of 1990-2003, although there was still room for improvement. Demand for voting shares, transparency, and tag along rights increased significantly. Enforcement of laws and regulations was consistent and predictable. Private initiatives provided incentives to bridge the gap between the existing legal framework and best practice for issuers who wanted to distinguish themselves while competing for capital. BOVESPA, IBGC, CVM and firms listed on the Novo Mercado were major drivers of change. Yet, the ownership structure continued to be highly concentrated and the high proportion of non-voting shares increased the potential for expropriation of minority shareholders.

3.2. The Evolution of Investor Protection in Chile

A few large pyramidal business groups control the Chilean corporate sector. At the top of their pyramids, there is usually an investment company, which operates as the control center of the business group. These investment companies are seldom listed on the stock exchange and have outsider shareholders (World Bank 2003, 1-2). Unlike Brazil, most shares are voting, but corporate ownership is also concentrated. The five largest shareholders concentrate on 57% of business group voting rights (Appendix 1.2). Pension funds that are

important institutional investors tend to invest in less concentrated companies due to regulatory constraints. Often times, share trading in Chilean stocks occurs abroad (World Bank 2003, 1-2).

Chile was the first country in Latin America to reform the legal and regulatory framework affecting investor protection (Aguilera 2009, 160), mainly composed of the Securities Market Law and the Corporation Law. Over the period studied, Chile modified its Corporation Law in 1994 and 2000 and its Securities Market Law in 1994, 2000, and 2001 (Chong and Lopez de Silanes 2007, 17).⁶⁰ A major change occurred in 2000 when the Corporate Governance Law was enacted and overhauled these two existing laws. As a result of these changes, the market for corporate control became more regulated and required that transactions involving changes of control be performed through a tender offer⁶¹ under a version of equitable treatment for shareholders. Since 2001, all shareholders of the same class of shares must be treated equally during changes of control. If shareholders oppose important corporate decisions, such as those concerning statutes, mergers, assets, shares, they have the right to sell their shares to the company at market price. If, over a change of control, shareholders deem that their rights have been violated, they can sue the directors and/or the company through an arbitration mechanism established in the Corporate Governance Law. Equal treatment has also been guaranteed to foreign shareholders⁶², especially regarding voting procedures (World Bank 2003, 2-3).

⁶⁰ These two laws were strongly influenced by U.S. law and practice, despite the Civil Law Tradition of the Chilean legal system.

⁶¹ A tender offer is an offer to purchase some or all of shareholders' shares in a corporation. The price offered is usually at a premium to the market price.

⁶² Mainly holders of American Depositary Receipts (ADR), that is a negotiable security that represents securities of a non-U.S. company that trades in the U.S. financial markets.

The new law introduced other improvements as well. It mandated board committees composed of a majority of independent members for large listed corporations. It allowed share purchase to implement stock option packages as incentives for executives. It established higher reporting and disclosure requirements for related party transactions (World Bank 2003, 2-3).

Despite these improvements, problems persisted affecting minority shareholder rights. It was difficult for them to discover whether their rights had been violated, because the information disclosed to them did not include all the connections among the firms of a business group. An illustration of this problem was related to one of the functions of the board: the evaluation, approval, or rejection of related party transactions. It was not easy to identify related parties when information about the ownership and control structure of most business groups was scant and complex. So, despite their efforts, misuse of corporate assets and abuse in related party transactions remained a problem in Chile (World bank 2003, 5-8).

In terms of legal enforcement and investor protection, the supervisory entity in charge of the key role was the Superintendence of Securities and Insurance (SVS). Among its faculties, the SVS regulated public companies, stock exchanges, brokerages, mutual and investment funds, and auditors of listed firms. It could also subpoena market participants, access private records, and impose sanctions. Like in Brazil, SVS worked on private arbitration under the Chamber of Corporations (Cámara de Sociedades Anónimas) and through special courts (World Bank 2003, 2-3).

Over the period under study, Chile did not develop self-commitment initiatives such as Novo Mercado in Brazil or private initiatives in corporate governance training, although the country had received recommendations to do so from the OECD. This organization had

proposed to create an Institute of Directors to provide training for supervisory board members, disseminate best practice, and promote dialogue between public and private sectors (World Bank 2003, 1).

Regarding the evolution of specific minority shareholder rights, Appendix 1.2 illustrates how minority shareholders in Chile remained protected with the legal right to receive at least 30% of dividends over the period studied. In terms of other rights, all but one remained. These consisted in a) the possibility for one candidate standing for election to the board to accumulate votes as well as having their interests proportionally represented on the board; b) selling shares prior to a general shareholders meeting; c) having the first opportunity to buy new issues of stock; d) calling for an extraordinary shareholders meeting with a minimum requirement of 10% of capital; and e) participating in some governance bodies. The one right that was eliminated after 2000 was the right to challenge fundamental decisions of the management or the assembly. This was usually done either by judicial venue or by requiring the firm to purchase shareholder holdings if the latter objected to fundamental changes. However, this last possibility had already been incorporated into the law, as mentioned above.

In short, Chile set the standards in terms of investor protection in the region. Investor protection in the country improved between 1990 and 2003. The legislative and regulatory framework dealing with investor protection was upgraded over this period. Chile observed most of the OECD Corporate Governance principles related to shareholder rights (Appendix 1.4) over the period studied (World Bank 2003)⁶³. Room for improvement still exists in areas such as disclosure, transparency, and board responsibilities. More resources towards the SVS

⁶³ For further discussion on OECD corporate governance principles, see www.OECD.org.

would allow for effective market surveillance and enforcement of shareholder rights (World Bank 2003, 5-7).

3.3. The Evolution of Investor Protection in Argentina

Most business groups in Argentina were family owned and structured as pyramids (World Bank 2006, 2) with a holding unit at the apex coordinating the rest. Over 75 percent of these families owned more than 50 percent of the equity of their businesses. Over 40 percent of business groups did not trade their capital on the stock market (Fracchia et al 2010, 335). The existence of dual class shares allowed for discrimination between shareholders with more or less voting rights, over the period studied (Appendix 1.2). This fact, along with the use of pyramidal structures, family members on the board, and interlocking directorates within business groups (Fracchia et al 2010, 336) contributed to the already high concentration of corporate decisions in the hands of family controlling shareholders.⁶⁴

Over the same period, no laws or law reforms were introduced affecting corporate governance or securities market (Chong and Lopez de Silanes 2007). Instead, some important changes affecting public disclosure, transparency provisions, investor protection rules, arbitration procedures, and regulation of related party transactions were introduced by means of Decree 677/01 in late May 2001. In particular, the rules to prevent abusive related party transactions were very strict and involved an independent assessment of the market terms over such deals before board approval (World Bank 2006, 1-3). However, the regulation the decree would rely upon were expected to be available in late November of the same year (Argentine Republic, Decree 677/01), a couple of weeks before the resignation of the

⁶⁴ But not between business groups.

president at the time, President Fernando De la Rúa. These were finally published in April 2002 (Argentine Republic, General Resolution 400/02 and General Resolution 401/02).

Despite the changes and introduction of strict rules, their implementation depended on the enforcement capacity of regulators and on independent and adequately protected directors and audit committees (World Bank 2006, 2-3).

The securities market regulator was the Securities Commission (*Comisión Nacional de Valores* - CNV). In theory, controlling shareholders, directors, auditors, and executives had the duty to inform the CNV, the public and the stock exchange about the shares of stock, convertible bonds, and options they owned. This ownership information had to be available to the public at the 5% direct ownership level. Failure to disclose caused the CNV to initiate proceedings against the shareholder, which could result in fines, listing suspension, or a ban on new public offerings. In practice, the available ownership information was not collected in a single database. It required visiting several institutions where records were incomplete and historical information needed to be compiled (World Bank 2006, 1-3).

The *Bolsa de Comercio de Buenos Aires* (BCBA) was long been responsible for the operation of the primary stock exchange in the country. It provided an arbitration tribunal to its members over many decades, but was under-used for investor protection issues (World Bank 2006, 2).

In 2001, a private sector initiative created the Argentine Institute for Corporate Governance (*Instituto Argentino para el Gobierno de las Organizaciones* - IAGO), which aimed at raising awareness towards good governance practices and providing director training (Aguilera 2009, 160). However, Argentina did not develop a voluntary Code of Best

Practices for Corporate Governance over the period under study (Alonso and Blume 2007), unlike Brazil and Chile.

Even if shareholders were entitled to protection mechanisms by law, few of them were workable in practice (World Bank 2006, 2). Few shareholders participated actively in corporate governance due to closely held ownership of listed companies. Moreover, sales of major corporate assets were not subject to shareholder meeting approval, unless they involved virtually all-substantial assets of the company (World Bank 2006, 2). Shareholders were not protected by minimum legal payments of dividends over the period, unlike in Brazil and Chile. Some minority shareholder rights that were in place in the 1990s were eliminated after 2000. One was the right to accumulate votes for one candidate to the board or to be proportionally represented on it. Another one was the right to challenge the decisions of the management or assembly on fundamental issues, either by judicial venue or by requiring the purchase of their shares. Practitioners had noted that, when in force, these procedures were either not followed in due form, ineffective, or not used (World Bank 2006, 2). Among the rights that remained in force over the period studied were the right to buy new issues of stock at the first opportunity and the right to call for extraordinary shareholder meetings with a minimum requirement of 5% of capital. No new rights were introduced over the period (Appendix 1.2).

In summary, investor protection deteriorated in Argentina over the period studied. There was a backward movement in terms of specific minority shareholder rights, despite the attempts to reform. Considerable room for improvement existed in terms of the enforcement capacity of the Securities regulator CNV, which had a substantial role in overseeing the self-regulatory institutions dealing with exchange and stock markets (World Bank 2006, 5). Other

areas requiring improvement were the monitoring of related party transactions; public disclosure of ownership information at the ultimate level; and control over auditor quality (World Bank 2006, 6).

In conclusion, corporate governance around the world changed between the early 1990s, when initiatives were exploratory and tentative and the early 2000s, when changes were more profound and emphasis was on effective implementation and visible results (World Bank 2006, 5). The revision of corporate governance rules or the lack of thereof affected investor protection. Reforms were attempted in the three countries over the period studied. As shown in Table 1.1, we classified the changes observed for each country according to their nature: legal reforms under the authority of governments; initiatives from the private sector; developments in terms of enforcement; and modifications of specific shareholder rights. In Brazil, legal reforms coupled with private sector initiatives, such as corporate self-commitment and codes of best practices, led to general improvement in the protection of investors. Chile implemented state-led changes in corporate governance that translated into sustainable improvements in investor protection in the early 1990s. In Argentina, there were no important changes registered in corporate governance during the 1990s. Although the government tried to introduce some reforms at the eve of its economic, political, and social crisis in 2001, investor protection receded over the period studied.

This research analyzes whether the evolution of investor protection can explain the evolution of business groups in Brazil, Chile, and Argentina at the turn of the twentieth and the twentieth first centuries. In the following pages, I will turn to the evolution of business groups and show how they followed different paths across these South American countries between 1990 and 2003.

Table 1.1: Evolution of Investor Protection in Brazil, Chile, and Argentina, 1990-2003

	Law Reforms		Private Initiatives		Enforcement	Minority Shareholder Rights	Evolution of Investor Protection
	Corporate	Securities	Self-Commitment	Code of Best Practices			
Brazil	Yes	Yes	Yes	Yes	Some Improvement	3 improvements 1 reversal	General Improvement
Chile	Yes	Yes	No	No	Some Improvement	No changes	General Improvement
Argentina	No	Yes (decree)	No	No	Deficit	2 reversals	General Deterioration

Source: Author

4. Business Groups in Brazil, Chile, and Argentina between 1990 and 2003

In the following pages, I present a comparative analysis of the evolution of a sample of the most relevant domestic business groups for each country between 1990 and 2003.⁶⁵

As discussed in the introduction to this dissertation, in the largest countries of Latin America, the ‘big push’ towards large-scale firms and industrialization⁶⁶ was put in place over three decades of import substitution industrialization policies (ISI) between the 1940s and the 1970s. These policies included the creation of SOE in strategic sectors, domestic market protection, preferential access to public procurement, as well as multiple exchange rates and loans at subsidized interest rates for domestic firms. Backed by these policies, many firms became business groups in Brazil, Chile, and Argentina. Despite their initial success, ISI policies revealed their weaknesses⁶⁷ in the 1970s. Coupled with higher international interest rates and lower international prices for Latin American commodities in the 1980s, many of these countries became unable to service their external debts. Economic stagnation spread throughout the region⁶⁸. Brazil, Chile, and Argentina were not exempt from this phenomenon. In their quest for the way out of macroeconomic instability and stagnation, towards development, most governments in

⁶⁵ For details about the sample, see appendix 1.4.

⁶⁶ In the largest countries of Latin America, export-oriented large firms operating in the natural resources sector as well as some industrial producers of nondurables, intermediate inputs, and construction goods already existed in the period of export-led growth between 1890 and 1930. These countries were Mexico, Brazil, Argentina and Chile (Haber 2006, 537).

⁶⁷ Domestic market protection induced local firms’ inefficiencies, made imports of capital goods expensive, and discouraged investment in technology. The higher production costs were transferred to consumers through higher prices or financed with fiscal deficits and international credit at low interest rates.

⁶⁸ “In August 1982, Mexico declared that it could no longer meet payments on its foreign debt. A few months later, Brazil, the largest borrower, followed suit. This triggered a worldwide crisis. Under the guidance of the International Monetary Fund, bankers lent additional money for ‘rescue’ loans. As a result, Latin America’s total debt rose from US\$242 billion in 1980 to \$431 billion by 1990. The region’s credit crisis was accompanied by a protracted economic crisis throughout the 1980s” (Skidmore et al 2010, 368).

Latin America turned to market-oriented reforms over the 1980s and 1990s. These reforms were usually a condition to obtain loans from multilateral banks. They included the privatization of SOE as well as trade and financial liberalization. Business groups in the region often encouraged their adoption, expecting to benefit from rapid privatization while circumventing the threat of trade liberalization. Similar reforms took place in Brazil, Chile, and Argentina, but with quite different results for business groups across the three countries.

4.1. Evolution of Business Groups in Brazil between 1990 and 2003

In Brazil, new domestic business groups emerged between 1990 and 2003. Privatization in the natural resources and utilities sectors as well as in some areas of manufacturing such as petrochemical, steel, production of aircrafts and air transportation led to the emergence of new business groups. This was the case of *Companhia Vale do Rio Doce*⁶⁹, Usiminas, CPFL Energia, Embraer, Neoenergia, Light, Oi Telemar, and Brazil Telecom. The privatization of Copesul and *Companhia Siderurgica Nacional* led to the expansion of business groups Odebrecht and Vicunha, respectively⁷⁰. The privatization of CPFL Energia, Usiminas, Oi, and Brasil Telecom allowed, to a lesser extent, for the expansion of Andrade Gutierrez, Bradesco, Camargo Correa, CR Almeida, Suzano, Vale, and Votorantim groups (Aldrichi and Postali 2010, 372-374). Another reason for business group expansion over the period was the internationalization of their operations of direct foreign investment led by companies like Vale (since 2000) and Gerdau (to Canada, Chile, Argentina, and the United States), and to a lesser extent,

⁶⁹ Despite its privatization, the state partook in the controlling coalition through equity holdings.

⁷⁰ Foreign corporations became the controllers of seven privatized firms: ArcelorMittal, Santander, AES Eletropaulo, Telefonica, Tim Brazil, Claro and Embratel (Aldrichi and Postali 2010, 372).

Camargo Correa, Odebrecht (to the European Union), Votorantim (since 2000), Embraer, and Ultrapar (to Argentina, the United States, and Mexico). These same business groups as well as Usiminas, FSB Friboi, Sadia, and Perdigao also expanded due to significant export operations during those years. They contributed in both ways to increase the role of Brazil in the world economy, supported by funds for foreign trade and internationalization from BNDES (Diniz and Boschi 2003, 17; Schneider 2009, 159-85; Aldrighi and Postali 2010, 383).

However, liberalization as well as international financial crises at the end of the decade made the environment more competitive and challenging, resulting in pressure to restructure business. Mergers and acquisitions (M&A) were common over the period, causing expansion in some business groups and shrinkage in others. Camargo Correa and Odebrecht expanded while Norquisa/Copene and Denerge were bought and controlled by Odebrecht and Grupo Rede, respectively. Yet, the most important effect of M&A was the increase of foreign capital participation in the Brazilian economy, involving 60% of more than 2,000 mergers and acquisitions over those years. In manufacturing, Antarctica first merged with Brahma into Ambev to be later acquired by foreign InBev. Foreign Arcelor Mittal and Bunge acquired Belgo Mineira and Santista, respectively. In the banking sector, Real was acquired by foreign ABN AMRO Bank while Sul America shrank, following a sale of stock to foreign ING Insurance. Furthermore, bankruptcy was not unusual in this sector as illustrated by the case of Bamerindus⁷¹, which was first intervened by the federal government and whose assets were later acquired by foreign British bank HSBC. Despite the increasing presence of foreign banks, the banking sector

⁷¹ Two smaller banks under similar conditions over the period were *Banco Economico* and *Banco Nacional* (Aldrighi and Postali 2010, 361).

remained dominated by three of the largest domestic business groups (Bradesco, Itau, and Unibanco) and protected *de facto* against foreign capital by government regulations⁷² (Diniz and Boschi 2003, 2; Schneider 2009, 159-85; Aldrichi and Postali 2010, 362-371). Table 1.2 provides details on these trends.

⁷² Although opened to foreign capital, the regulations of the banking sector had been protective.

Table 1.2: Evolution of Business Groups in Brazil, 1990-2003

Business Group	Emergence		Expansion				Contraction	
	Privatization	Other	Privatization	International	M&A	Other	M&A	Financial distress
Andrade Gutierrez			x					
Antarctica							x	
Aracruz								
Bamerindus							x	x
Belgo Mineira							x	
Bradesco			x					
Brasil Telecom	x							
Camargo Correa			x	x	x			
CPFL Energia	x							
CR Almeida			x					
CSN - Vicunha			x					
Denerge							x	
Embraer	x			x				
FBS Friboi				x				
Gerdau				x				
Itamarati								
Itausa								
Klabin								
Light	x							
Lojas Americanas								
Mendes Junior								
Neenergia	x							
Norquisa/Copene							x	
Odebrecht			x	x	x			
Oi	x							
Pao de Acucar								
Perdigao				x				
Real							x	
Sadia				x				
Santista							x	
Sul America								
Suzano		x	x					
TAM								
Ultra				x				
Unibanco								
Usiminas	x			x				
Vale	x		x	x				
Votorantim			x	x				

Source: Author based on Aldrichi and Postali (2010) and firms' websites.

4.2. Evolution of Business Groups in Chile between 1990 and 2003

In Chile, domestic business groups consolidated between 1990 and 2003⁷³. Privatization in utilities, steel and banking, along with internationalization of business in South America, led to the expansion of Claro, Fernandez Leon, Hurtado Vicuña, and Marin Del Real groups through direct foreign investment and exports. Indeed, internationalization was a source of expansion during this period for almost every business group studied. This was partly because the Chilean State promoted internationalization by co-financing projects of group firms through PROCHILE⁷⁴, thus, encouraging alliances between them to explore foreign markets (Perez Aleman 2003, 203). In particular, industries grew in the natural resources sector (mining, forestry, fruit, and fisheries) fostered by export promotion policies,⁷⁵ and expanded their operations to other countries in Latin America. This was the case of the Matte group. Transport, logistics, and infrastructure sectors also expanded, associated with increasing export activities, as in the Urenda group (Lefort 2010, 391-2, 410). Mergers and acquisitions in the domestic market, coupled with internationalization, explained the expansion of many business groups. This was the case of CAP, Ponce, and Angelini⁷⁶ in natural resources; of Sigdo Koppers in manufacturing; and of Paulmann and Solari/Cuneo/Del Rio in retail. In this last sector, large firms developed into business groups, merging with or acquiring

⁷³ It is worth noting that during the first round of privatizations in Chile, business groups were able to include industrial firms as well as financial institutions while the incipient private pension system was not authorized to hold share of firms. This financial structure proved to be a mistake over the 1982 crisis. Some business groups were dissolved (Vial and BHC groups), others shrank in size (Cruzat-Larrain group) while other, financially stronger, consolidated (Angelini and Luksis groups) (Lefort and Walker 2007, 389-393).

⁷⁴ PROCHILE is an agency of the Chilean Government in charge of promoting exports and attracting foreign direct investment.

⁷⁵ Since 2000, business groups in this sector benefited from a boom in commodities prices.

⁷⁶ The performance of the Angelini group, for example, is partly explained by its exports in forestry, fishing and wine, its foreign direct investment in Argentina buying a cellulose plant in 1996, and its mergers and acquisitions of smaller companies of two fishing firms in the domestic market (Lefort 2010, 391-413).

other firms including ones owned by multinationals; incorporating consumer financial services and real estate; and going international, especially for Peru, Colombia, and Argentina (Lefort 2010, 392, 414). The development of the insurance sector in the domestic market was another reason behind the expansion of domestic business groups with core business in the financial sector, like Larrain Vial, Penta, and Yarur. Despite their expansion, this sector was dominated by foreign banks (Santader, BBVA, Scotiabank, ING, and Itau) that acquired many financial institutions over the period (Lefort 2010, 391-392, 410, 414, 416).

Lastly, several factors operating simultaneously were behind the favorable evolution of the Luksic, Penta and Saieh groups. Being one of the oldest business groups in Chile together with Angelini and Matte, Luksic was exceptionally authorized⁷⁷ to operate both in the industrial and financial sectors. Over this period, the business group expanded due to privatization, internationalization, mergers and acquisitions, as well as the development of the domestic financial market. Penta, the financial group formed by five former executives of Cruzat Larrain, expanded due to internationalization, mergers and acquisitions, and the development of the domestic financial market. The only new domestic business group that emerged during the period was the one controlled by the Chilean businessmen Alvaro Saieh, which operated mainly in financial services and insurance and to a lesser extent in retail, real estate, telecommunications, and media. This business group also expanded due to internationalization, mergers and acquisitions, and the development of the domestic financial market over the period (Table 1.3).

⁷⁷ After the 1982 crisis, legal reforms established a clear separation between industrial and financial business groups (Lefort 2010, 391).

Table 1.3: Evolution of Business Groups in Chile, 1990-2003

Business Group	Emergence		Expansion				Contraction	
	Privatization	Other	Privatization	International	M&A	Other	M&A	Financial distress
Angelini				x	x			
Calderon								
CAP				x	x			
Claro			x	x				
Fernandez Leon			x	x				
Hurtado Vicuna			x	x				
Ibanez				x				
Larrain-Vial				x		x		
Luksic			x	x	x	x		
Marin - Del Real			x	x				
Matte				x				
Paulmann				x	x			
Penta				x	x	x		
Ponce				x	x			
Said				x				
Saieh		x		x	x			
Sigdo Koppers				x	x			
Solari - Cuneo - Del Rio				x	x			
Urenda				x				
Yarur				x		x		

Source: Author based on Lefort (2010) and firms' websites

4.3. Evolution of Business Groups in Argentina between 1990 and 2003

In Argentina, domestic business groups experienced booms and bursts during this time. Until the mid 1990s, business groups expanded through privatization in oil, steel, petrochemicals (Perez Companc, Bulgheroni, Techint, Garovaglio & Zorroaquin), utilities (Acindar, Aluar/Fate, Cartellone, Pescarmona, Sociedad Comercial del Plata, and Werthein), and transport sectors (Aceitera General Deheza, Eurnekian, Fortabat, Perez Companc, Roggio, Sociedad Comercial del Plata, and Socma). Some of them expanded, maintaining (Aceitera General Deheza, Aluar, Arcor, Bunge & Born, and Techint) or developing an international business orientation (Coto, Eurnekian, and Pescarmona) either through exports or direct foreign investments. Mergers and acquisitions were common over the period, but caused more shrinking and transfer to foreign hands than expansion of domestic business groups. *Sociedad Comercial del Plata* (SCP) merged with Astra and Isaura and sold their assets in the oil sector to Spanish oil company Repsol in 1996. The same year, Garovaglio and Zorroaquin (G&Z) sold their assets in Polisur to Dow Chemical and reoriented its business to agribusiness. Bulgheroni sold part of their assets to the American oil company Amoco in 1997. The following year, the Werthein group merged the assets of its bank with Caja de Ahorro Bank. The same year, Perez Companc bought the food-processing firm Molinos from the landed related Bunge & Born and Acindar sold their assets to the Brazilian Belga Mineira. Until the mid 1990s, new business groups emerged in retail (Coto), retail and finance (Banco Velox/Disco) as well as real estate (IRSA) (Fracchia et al 2010, 344-347). Unlike Brazil, no domestic business group emerged from the many privatizations completed over the period.

Over 1998 and 2003, more business groups shrank and sold all or part of their assets. Perez Companc sold all the assets of Banco Rio to Spanish Banco Santander in 1999, all the assets of its oil company to the Brazilian state-owned Petrobras in 2002, and reoriented its activities to agribusiness. This strategy of restructuring and reorientation from highly competitive sectors at the international level (oil, petrochemicals, and energy) to sectors where the country had a competitive advantage (agribusiness) was also successfully followed by Bunge & Born and to a lesser extent by Wertheim. However, other business groups were not able to restructure successfully, experienced financial distress generated even before 2001, or were highly indebted in dollars (Alpargatas, Banco Velox/Disco, Coto, Fortabat, G&Z, and Roman). Accordingly, many of them ceased to exist, adding to Acindar that had already sold in the late 1990s. SCP went into receivership in 2000. The Brazilian group Brahma bought Bemerg in 2002. Garovaglio and Zorraquin sent its meat-processing firm CEPA into receivership in 2000 to finally sell its assets to Brazilian group JBS Friboi in 2004. After intervention in 2003, the assets of Banco Velox/Disco were sold to the Chilean group Paulmann in 2004. After years of financial difficulties, Fortabat and Alpargatas sold their firms to Brazilian groups Camargo Correa in 2005 and Vicuhna in 2008, respectively. Nevertheless, other business groups grew, buying assets of foreign firms quitting the domestic market after devaluation and default. This was the case of Eurnekian that bought assets in *Aerolíneas Argentinas* from Spanish hands in 2002 and of Wertheim that bought assets in telecommunications from France Telecom in 2003 (Fracchia et al 2010, 331, 344-7). Table 1.4 displays the changes in business groups in Argentina over this period.

Table 1.4: Evolution of Business Groups in Argentina, 1990-2003

Business Groups	Emergence		Expansion				Contraction	
	privatization	Other	Privatization	International	M&A	Other	M&A	Financial distress
Aceitera General Deheza			x	x				
Acindar			x				x	x
Alpargatas								x
Aluar/Fate			x	x				
Arcor				x	x			
Banco Velox/Disco		X						x
Bemberg							x	x
Bulgheroni			x				x	
Bunge & Born				x			x	x
Cartellone			x					
Coto		X		x	x			x
Eurnekian			x	x	x			
Fortabat			x					x
G&Z			x				x	x
IRSA		X						
Ledesma								
Perez Companc			x		x		x	x
Pescarmona			x	x				
Roggio			x					
Roman								x
SCP			x				x	x
Socma			x					
Techint			x	x				
Wertheim			x		x		x	

Source: Author based on Fracchia et al (2010) and firms' websites.

4.4. Comparative Evolution of Business Groups

Business groups followed different paths across these countries between 1990 and 2003. In Table 1.5, I show the number of business groups that grew through emergence or expansion and the number of those that contracted because of M&A, financial distress, or bankruptcy for each country over this period. I also show the stylized result of this process: emergence and expansion took place as well as acquisitions by foreigners in Brazil; expansion happened in Chile; and shrinking and elimination as well as acquisitions by foreigners took place in Argentina.

In Brazil, privatization in effect gave birth to new domestic business groups. Unlike the existing ones owned by traditional families, the ownership of new domestic business groups belonged to coalitions of shareholders (including families, pension funds, the state) like Brazil Telecom, CPFL Energia, JBS Friboi, Light, Neoenergia, Oi, Usiminas, and Vale or was dispersed like Embraer. The expansion that many domestic business groups experienced over the period was due to their participation in privatization or to the internationalization of their business. In either case, firms were supported by the state through BNDES. This performance was not related to any particular sector of the economy. Among the business groups that expanded were very diversified ones (Bradesco and Odebrecht) as well as focused ones (Perdigao and Sadia). This period brought economic concentration of resources into the hands of domestic business groups in terms of electric energy, steel, petrochemicals, as well as transport and infrastructure, mainly due to privatization. Yet, foreigners also concentrated resources due to mergers and acquisitions (food and beverages, steel, textiles, and banking) and to a lesser extent due to privatization (telecommunications and electric energy). Indeed, the participation of

foreign capital increased inside the economy and foreign owned firms were among the biggest ones in Brazil over the period. Finally, all domestic business groups that took part in privatization fared well (see Table 1.5).

In Chile, domestic business groups consolidated and expanded mainly through internationalization. Like in Brazil, the state supported this strategy with policies that also fostered intergroup cooperation. It was not unusual that the ownership of business groups was in the hands of a coalition of shareholders (Penta, Ponce, Said, Sigdo Koppers) or was dispersed (CAP). Like in Brazil, mergers and acquisitions as well as privatization contributed to the expansion of business groups. But they favored the economic concentration of the economy in the hands of domestic business groups as well as foreigners, and together controlled 90% of the assets of the biggest firms in 2002 (Lefort 2010, 397). Unlike Brazil, foreign capital controlled the most important firms in financial services, such as Santander Chile and in utilities, such as Enersis, Compania de Telefonos de Chile, and Aguas Andinas. The foreign one emerged over this period (Lefort 2010, 395). The domestic business group that emerged was favored by the development of the Chilean financial market, which also allowed for the expansion of existing business groups. Thus, all domestic business groups fared well between 1990 and 2003. Many participated in privatization before and during this time (see Table 1.5).

Unlike Brazil, privatization in Argentina did not create new domestic business groups, but was the reason behind the initial expansion of many of them. Internationalization was another source of expansion as well as an outward oriented strategy during the crisis years. However, unlike Brazil and Chile, the internationalization of business groups was not supported by long standing governmental agencies or

systematic policies. Mergers and acquisitions were sometimes sources of expansion while at other times signs of restructuring, shrinking, or elimination of business groups. Like Brazil and Chile, they were also the way in which foreign capital, particularly Spanish and Brazilian, increased their participation in the economy. Indeed, domestic business groups owned two-thirds of the firms belonging to big business units in 1993; half of them in 2000 (pre-default); and foreign corporations owned almost 60% of them in 2003. The number of foreign owned firms increased, while group-affiliated firms decreased, resulting in a net loss of total firms. Unlike Brazil and Chile, half of the domestic business groups studied fared badly. Half of them had previously expanded through privatization in oil (Perez Companc, Bulgheroni), electric energy (Werthein), transport and infrastructure (Aceitera General Deheza, Sociedad Comercial del Plata), steel (Acindar) and petrochemicals (Garovaglio & Zorroaquin). Finally, among the three domestic business groups that emerged over the period, one of them ceased to exist by 2003 (Banco Velox/Disco) adding to the elimination of two existing business groups (G&Z and SCP) (Table 1.5).

In the following section, I will explain why the evolution of investor protection does not appear to have had much if any effect on the evolution of business groups in Brazil, Chile, and Argentina during the 1990-2003 period.

Table 1.5: Evolution of Business Groups in Brazil, Chile, and Argentina, 1990-2003

Number of business groups between brackets

	BRAZIL	CHILE	ARGENTINA
GROWTH	Emergence (8) Expansion (16)	Emergence (1) Expansion (19)	Expansion (18)
CONTRACTION	M&A (7) Financial distress (1)	NA	M&A (8) Financial distress (11) Ceased to exist (2)
STYLIZED RESULT	EMERGENCE & EXPANSION ACQUISITIONS BY FOREIGNERS	EXPANSION	SHRINKING & ELIMINATION ACQUISITIONS BY FOREIGNERS

Source: Author, based on Colpan et al (2010) and *Instituto Nacional de Estadísticas y Censo* (Argentina)

5. Summary

I have mentioned that a significant part of corporate governance literature (La Porta et al 1999; Burkart et al 2002; Khanna and Yafeh 2007) supports the thesis that free standing and widely-held firms are more prevalent in countries with better legal protection for investors against pilfering by insiders. In contrast, business groups, wherein blocks of shares and control are concentrated among fewer hands are more prevalent in countries with lower levels of legal and regulatory protection for public shareholders.

I agree with these authors. I acknowledge that business groups in Brazil, Chile, and Argentina originated in the context of poor investor protection, with limited legal enforcement, imperfect property rights, and imperfect information in capital markets.

Inspired by this literature, this paper investigates whether changes in investor protection had an impact on the evolution of business groups. I want to know if as investor protection grows stronger, whether business groups become less prominent? And conversely, if investor protection deteriorates, whether business groups become more commonplace?

As shown in Table 1.6, I find no evidence about the evolution of investor protection and of business groups in Brazil, Chile, and Argentina over 1990 and 2003 that supports a negative correlation between these two variables.

In Brazil, legal reforms and enforcement in conjunction with private sector initiatives led to a general improvement in investor protection while business groups emerged. Some even merged or were acquired over the period studied.

In Chile, sustained legal changes improved investor protection while the biggest business groups continued to expand between 1990 and 2003.

In Argentina, no significant changes could be introduced. Investor protection deteriorated over the period while many business groups sold part or all of their assets due to mergers, acquisitions and financial distress.

Hence, changes in investor protection do not explain the performance of business groups in Brazil, Chile, and Argentina between 1990 and 2003. According to the standard thesis, investor protection cannot account for the patterns of changes observed in business groups as documented. Indeed, a positive relationship between the improvement of investor protection and the prevalence of business groups where control is concentrated is closer to the evidence presented in this paper.

Table 1.6: Investor Protection and Business Groups in Brazil, Chile, and Argentina, 1990-2003

Country	Evolution of Investor Protection				Evolution		Correlation consistent with hypothesis
	Law Reforms	Private Initiatives	Enforcement	Minority Shareholder Rights	Investor Protection	Business Groups	
Brazil	Yes	Yes	Improvement	Improvement	IMPROVED	FARED WELL	NO
Chile	Yes	No	Improvement	Stable	IMPROVED	FARED WELL	NO
Argentina	No	No	Deficit	Deterioration	DETERIORATED	FARED BADLY	NO

Source: Author

This standard hypothesis centers on the concept of pyramidal business groups. One possible explanation as to this discrepancy is that the business groups under study cannot be considered *pyramid* structures. Although there are differences in the quality of information, there is a widespread consensus in the literature that business groups are the predominant corporate form in Latin America and that pyramids are their predominant structure in the three countries (OECD 2004). In the case of Chile, Lefort and Walker (2000) reported that 68% of the non-financial listed firms were controlled by business groups, mostly pyramid structures. In the case of Brazil, Khanna and Yafeh (2000) found that 89% of the 39 listed firms analyzed in their study were affiliated to business groups through pyramids. Despite lack of precise information about the use of pyramids in Argentina, these same authors found that 93% of the 24 listed firms they analyzed were affiliated to business groups, also through pyramids.

Another possibility is that the relevant element is not tunnelling per se, but rather the *use* of tunneled resources. For example, dividends that should go to investors may be used to acquire a new firm, causing business groups to grow. They may also be used to increase the personal wealth of controlling shareholders, thereby hardly benefiting business groups. The likelihood of these alternatives is related to investor protection. Stronger investor protection would lead to a higher likelihood of reinvesting tunneled resources into the business group, causing its growth. Yet, there is little or no information that distinguishes policies protecting investors against tunnelling from policies protecting them against particular uses of tunneled funds.

A last explanation as to the discrepancy found in the standard hypothesis is that the idea of *conflict* it is built upon may be inappropriate. The theory behind this

explanation states that a conflict of interest between controlling and minority shareholders lies at the core of a business group. Nothing is said in the corporate governance literature about the need to identify the conflicting parties. The role the State plays in regulating such a situation is important to investigate especially when the State happens to be either a controlling or minority shareholder. The standard explanation does not take into account the relation between the State and business groups, or other political and institutional factors. This is what the next chapter will focus on in order to explain the different patterns of evolution between business groups in Brazil, Chile, and Argentina over 1990 and 2003.

6. Conclusion

Corporate governance literature has found a negative relation between the quality of investor protection and prevalence of business groups, highlighting the concentration of corporate control. In this study, I have analyzed whether the evolution of investor protection in Brazil, Chile, and Argentina between 1990 and 2003 explained the evolution of business groups in the three countries over the same period.

I argue that investor protection improved in Brazil and Chile and deteriorated in Argentina between 1990 and 2003 by demonstrating changes in laws, legal enforcement, private initiative and specific minority shareholder rights in the countries and period studied. I also argue that business groups fared well in Brazil and Chile and badly in Argentina between 1990 and 2003 by highlighting the emergence, expansion, and contraction of a sample of the most relevant business groups of each country. I have demonstrated that investor protection improved while business groups fared well in Brazil and Chile between 1990 and 2003 and that investor protection deteriorated while business groups fared badly in Argentina over the same period.

Therefore, I have found no evidence of a negative correlation between changes in investor protection and the evolution of business groups in the three countries between 1990 and 2003. I argue that changes in investor protection over this period do not appear to have had much if any effect on the evolution of business groups in Brazil, Chile, and Argentina between 1990 and 2003.

In the next chapter, I argue that the different patterns of evolution of business groups across countries over the same period can be explained by the role of the State in business groups financing.

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Appendix 1.1: Definition of Selected Variables as Proxies for Minority Shareholder Rights

Variable	Definition
One-share-one-vote	This rule means each common share in a publicly traded company represents one vote at meetings of shareholders, as opposed to non-voting shares
Proxy by mail	The rule that allows shareholders to mail their proxy vote to the firm.
Shares not blocked	It is the rule that does not allow a firm to require shareholders to deposit their shares prior to a general shareholder meeting, thus preventing them from selling those shares for a number of days.
Cumulative or proportional representation	It is related to the regulations allowing shareholders to accumulate all their votes for one candidate to the board of directors. Without this possibility, they would not be represented. Proportional representation is the mechanism by which minority interests name a proportional number of directors to the board
Capital to call a meeting	It refers to the minimum percentage of equity that entitles a shareholder to call for an extraordinary meeting, usually from 1 to 33%
Pre-emptive rights	It refers to the possibility for shareholders to have the first opportunity to buy new issues of stock
Oppressed minorities remedies	These rules grant minority shareholders a judicial venue to challenge management and assembly decisions. It also gives them the right to require that the company purchase their shares if they object to fundamental changes, such as mergers and acquisitions.

Source: La Porta et al (1998), Chong and Lopez de Silanes (2007), Djankov et al (2006).

Appendix 1.2: Minority-Shareholder Rights in Brazil, Chile, and Argentina, 1995-2005

	Brazil			Chile			Argentina		
Types of Shares	Predominantly nonvoting: up to 2/3 K			Almost exclusively voting (1share=1vote)			Dual class shares		
Control Concentration	Largest 5 shareholders: 89% voting rights Use of pyramids			Largest 5 shareholders: 57% voting rights Use of pyramids			High ownership concentration Use of pyramids		
Dividends Policy	Minimum legal payment 25%			Minimum legal payment 30%			N/A		
Other Rights (*)	1995	2000	2005	1995	2000	2005	1995	2000	2005
Proxy by mail	No	No	Yes	No	No	No	No	No	No
Shares not blocked	Yes	Yes	No	Yes	Yes	Yes	No	No	No
Representation	No	No	Yes	Yes	Yes	Yes	Yes	Yes	No
Pre-emptive rights	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Oppressed minority	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	No
% Capital to call meetings	5%	5%	5%	10%	10%	10%	5%	5%	5%

Sources: Author based on from Chong and Lopez de Silanes (2007), Lefort & Walker (2007), Leal & Carvalhal (2007), Bebczuk (2007)

Note: (*) For detailed definition of these rights, see Appendix 1.1

Appendix 1.3: OECD Corporate Governance Principles

Principles regarding Rights and Equitable Treatment of Shareholders

1. The corporate governance framework should protect shareholder rights. Basic shareholder rights include the right to: (1) secure methods of ownership registration; (2) convey or transfer shares; (3) obtain relevant information on the corporation on a timely and regular basis; (4) participate and vote in general shareholder meetings; (5) elect members of the board; and (6) share in the profits of the corporation.

2. Shareholders have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes, such as: (1) amendments to the governing documents of the company; (2) the authorization of additional shares; and (3) extraordinary transactions resulting in the sale of the company.

3. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings. They should be informed of the rules, including voting procedures, that govern them. (1) Shareholders should be offered sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting. (2) Opportunity should be provided for shareholders to ask questions of the board and place items on the agenda at general meetings, subject to reasonable limitations. (3) Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

4. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

5. Markets for corporate control should be allowed to function in an efficient and transparent manner. Anti-takeover device should not be used to shield management from accountability.

6. Shareholders, including institutional investors, should consider the costs and benefits of exercising their voting rights

7. The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights. All shareholders of the same class should be treated equally. (1) Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the voting rights attached to all classes of shares before they purchase. Any changes in voting rights should be subject to shareholder vote. (2) Votes should be cast by custodians or nominees in a manner agreed upon with the share's beneficial owner.

8. Insider trading and abusive self-dealing should be prohibited.

9. Members of the board and managers should be required to disclose any material interests in transactions or matters affecting the corporation.

Source: www.OECD.org, accessed November 7, 2015

Appendix 1.4: Sample of Business Groups under Study in Brazil, Chile, and Argentina

The sample of business groups studied was based on the samples of the most relevant business groups in size for each of the countries identified in *The Oxford Handbook of Business Groups* (Colpan, Hikino, and Lincoln 2010).

For Brazil, I worked with the sample of 24 domestic private business groups studied by Aldrichi and Postali (2010). To their sample, I added 14 business groups identified by the authors as top 20 business groups over 1990-2003. The objective of this addition was to include important business groups at the beginning of the 1990s that shrank by the 2000s. Last, I excluded one economic unit (Safra) that was not a business groups according to the definition followed in this work. The resulting sample were the following 38 business groups: Andrade Gutierrez, Antarctica, Aracruz, Bamerindus, Belgo Mineira, Bradesco, Brasil Telecom, Camargo Correa, CPFL Energia, CR Almeida, CSN Vicunha, Denerge, Embraer, JBS Friboi, Gerdau, Itamarati, Itausa, Klabin, Light, Lojas Americanas, Mendes Junior, Neoenergia, Norquisa/Copene, Odebrecht, Oi, Pao de Acucar, Perdigao, Real, Sadia, Santista, Sul America, Suzano, TAM, Ultra, Unibanco, Usiminas, Vale, and Votorantim.

For Chile, I used the sample of 20 domestic private business groups studied by Lefort (2010): Angelini, Calderon, CAP, Claro, Fernandez Leon, Hurtado Vicuna, Ibanez, Larrain-Vial, Luksic, Marin-Del Real, Matte, Paulmann, Penta, Ponce, Said, Saieh, Sigdo Koppers, Solari-Cuneo-Del Rio, Urenda, and Yarur.

For Argentina, I worked with the sample of domestic private business groups studied by Fracchia et al (2010). I excluded some of economic units included by the authors. Sancor was a cooperative and did not correspond to the definition of business group followed in this work. Bago and Sidus (pharmaceutical) as well as Clarín and La Nación (media) were excluded in order to keep the three samples comparable in terms of the economic sectors included. This resulted in a sample of the following 24 business groups for Argentina: Aceitera General Deheza, Acindar, Alpargatas, Aluar/Fate, Arcor, Banco Velox-Disco, Bemberg, Bulgheroni, Bunge&Born, Cartellone, Coto, Eurnekian, Fortabat, Garovaglio&Zorroaquin, Irsa, Ledesma, Perez Companc, Pescarmona, Roggio, Roman, Sociedad Comercial del Plata, Socma, Techint, and Werthein.

Essay 2. Public Policies towards Business groups in Brazil, Chile and Argentina: How the State Affects Corporate Governance through Equity Financing, 1990-2003

1. Introduction

A business group is a set of legally independent firms bound together by equity and social ties and usually organized in pyramid fashion with a controlling shareholder at the top. The latter is usually a wealthy family that exerts control over all of the group's firms. Their collective value goes far beyond the actual wealth of the controlling shareholder.

Business groups are ubiquitous in most developed countries and prominent in developing ones. In Brazil, Chile, and Argentina, most of them emerged in the middle of the twentieth century fostered by import substitution industrialization policies and grew due to privatizations programs at the end of the same century. Why have they evolved so differently since then? In Brazil, business groups have emerged and expanded due to privatizations and internationalization. Some were merged or acquired. In Chile, the biggest business groups have expanded due to internationalization, privatizations, and mergers and acquisitions. In contrast, in Argentina, many business groups that had grown due to privatizations, sold part or all of their assets due to mergers, acquisitions and financial distress.

This paper argues that their different pattern of evolution over the period 1990-2003 can best be explained by the differences in state involvement in business financing rather than by the usual explanation of investor protection. I do find that business groups fared better where the state was involved in equity financing of business. Equity financing policies affected the governance structure of business groups enabling them to provide finance with domestic savings without losing corporate control while reducing bankruptcy risks in face of negative external financial shocks.

In the three cases under study, business groups have been present and of importance throughout the twentieth century. Their study over the period 1990-2003 is interesting because while business groups were still experiencing the consequences of market-oriented reforms and perceived as the winners of those policies, they faced negative external shocks due to the international financial crisis that affected the developing world in the late 1990s. Additionally, access to information was easier and data more reliable over this period because the three countries were under democratic rule. The study ends in 2003 because of the boom in commodity prices, which opened a new international context for developing countries.

This work brings together previous research about business groups and state financing in the three countries under study. It builds new statistical evidence using the databases from the Economatica system containing information on business groups and capital markets in the three countries under study. It adds statistical evidence about the evolution of different sources of business financing between 1990 and 2003. It compares the pattern of evolution of business groups and business financing across Brazil, Chile, and Argentina. Therefore, the methodological approach is a comparison of three case studies, in each of which we concentrate on a sample of the most important business groups.

The study proposes an explanation for the evolution of business groups based on the state involvement in equity financing of business. To do so, I make use of a literature that could be called the ‘political economy of corporate governance’ (Rosenstein-Rodin 1943; Gerschenkron 1962) to which I add a capital markets emphasis. As Gourevitch and Shinn (2005) assert, “the consequences of corporate governance systems have (...) been

insufficiently appreciated”. Indeed, comparative work studying the political economy of corporate governance of business groups in Brazil, Chile and Argentina during the 1990s is not usual.

The paper is structured in five sections. The following one presents a synthesis of the evolution of business groups in Brazil, Chile, and Argentina during 1990-2003. The third one offers a literature review on business groups from a political economy perspective. In the fourth section, I present the evolution of business financing in Brazil, Chile, and Argentina over the period under study and explain why state involvement in equity financing explains the evolution of business groups in the three countries. The last section provides a conclusion to the study.

2. Business Groups around the world and in Brazil, Chile, and Argentina

As mentioned in the previous chapter of this dissertation, business groups are a way of organizing big business wherein a few shareholders own large blocks of shares and control corporate decisions. In Western Europe, South East Asia, and Latin America, they are usually structured as a pyramid. As Khanna and Yafeh state, *a business group is a set of legally independent firms usually operating in diversified sectors and organized after the fashion of a pyramid with a controlling shareholder located at the apex* (Khanna and Yafeh 2007, 331). It is worth recalling that the controlling shareholder, usually a wealthy family, exerts control over all the firms of the group, whose collective value is far beyond its own wealth. Through equity and social ties among firms, the controlling shareholder controls not just one but many firms that are collectively worth substantially more than its own wealth (Morck et al 2005, 659, 663). Thus, a pyramid is an organizational arrangement that can subtract the power of control from those who own

the firm. (This extended control has been explained in detail in figure 1.1 of the previous chapter).

As mentioned in the previous chapter, many firms became business groups in the largest countries of Latin America backed by import substitution industrialization policies (ISI) between the 1940s and the 1970s⁷⁸. These policies included multiple exchange rates and loans at subsidized interest rates for domestic firms, domestic market protection, preferential access to public procurement, and also the creation of SOE in strategic sectors⁷⁹. Despite their initial success, ISI policies revealed their weaknesses in the 1970s: coupled with higher international interest rates and lower international prices for Latin American commodities in the 1980s, many of these countries were unable to service their external debts. Economic stagnation spread throughout the region. Brazil, Chile, and Argentina were not exceptions. In their quest for development and a way out of macroeconomic instability and stagnation, most governments in Latin America turned to market-oriented reforms over the 1980s and 1990s. These reforms included the privatization of SOE as well as trade and financial liberalization, usually representing a condition to obtain loans from multilateral banks. Business groups in the region often encouraged their adoption and expected to succeed through privatization while circumventing the threats of trade liberalization. Similar reforms took place in Brazil, Chile, and Argentina, but with different results for business groups across each country.

⁷⁸ It is worth noting that Haber argues that Latin American industrialization was the result of “an endogenous process of economic development, the roots of which were found in the growth of the so-called export economy”, and of ad hoc policies and “not the product of carefully thought-out plans or strategies” (2006, 584). Bulmer-Thomas makes a similar argument: “the protection offered to industry had been ad hoc, often inconsistent, and geared to the defense of the balance of payments rather than the needs of industry” (2003, 270).

⁷⁹ In many cases, the creation of SOE was built on the nationalization of previously foreign owned firms, such as railways, telecommunications, electric energy, and ports facilities.

As detailed in a previous chapter of this dissertation, privatizations in Brazil gave birth to new domestic business groups. Unlike the existing ones owned by traditional families, the ownership of new domestic business groups was either in the hands of coalitions of shareholders (including families, pension funds, the state) or was dispersed⁸⁰. The expansion that many domestic business groups experienced over this period was due to their participation in privatization or internationalization of their business. In either case, firms were supported by the State through its development bank (*Banco de Desenvolvimento Economico y Social* - BNDES). This performance was not related to any particular sector of the economy. Among the business groups that expanded were both some very diversified ones as well as focused ones. This period delivered economic concentration of resources into the hands of domestic business groups controlling electric energy, steel, petrochemicals, as well as transport and infrastructure, mainly due to privatization. Yet, foreigners also concentrated their resources due to mergers and acquisitions in sectors such as food and beverages, steel, textiles, and banking and to a lesser extent to privatizations in telecommunications and electric energy. Indeed, foreign capital participation in the economy increased over this period. Their firms were among the biggest ones in Brazil. All domestic business groups that took part in privatizations fared well (Table 2.1).

In Chile, domestic business groups consolidated and expanded mainly through internationalization. Like in Brazil, the State supported this strategy with policies that also fostered cooperation between groups. It was not unusual that the ownership of

⁸⁰ The development of financial markets in the last decades of the twentieth century coupled with the introduction of new regulations in capital markets favoured the emergence of new investors such as pension funds and shareholders' coalitions, especially in Brazil and Chile. Transfer of ownership tends to be more frequent in such cases.

business groups be in the hands of coalitions of shareholders or dispersed. Like in Brazil, mergers, acquisitions and privatization contributed to the expansion of business groups. It favored the economic concentration of the economy in domestic business groups and together with foreigners controlled 90% of the assets of the biggest firms in 2002. Unlike Brazil, foreign capital controlled the most important firms in financial services and utilities (electricity, water supply, telecommunications). The domestic business group that emerged over the period was favored by the development of the Chilean financial market (Lefort 2010, 395-7), which also allowed for the expansion of existing business groups. Thus, all the domestic business groups fared well between 1990 and 2003. Many participated in privatizations before and over this period (Table 2.1).⁸¹

Unlike in Brazil, privatization in Argentina did not create new domestic business groups, but was the reason behind the initial expansion of many of them. Internationalization was another source of expansion as well as an outward oriented strategy during the crisis years. But unlike Brazil and Chile, the internationalization of business groups was not supported by long standing governmental agencies or systematic policies. Mergers and acquisitions were at times a source of expansion and at others a signs of restructuring, shrinking, or elimination of business groups. Like Brazil and Chile, they were also the way in which foreign capital increased their participation in the economy, particularly Spanish and Brazilian. Indeed, domestic business groups owned two-thirds of the firms belonging to big business units in 1993; half of them in 2000 (pre-default); foreign corporations owned almost 60% of them in 2003. The number of foreign

⁸¹ Despite restructuring and financial crisis, these business groups could maintain the installed capacity in operation and preserve jobs as well as domestic and international markets. In the case of Brazil, they were key actors in the growth and internationalization of the economy in the 2000s. Although it is beyond the scope of this work, some scholars may be interested in the analysis of these facts from the perspective of the dependence theory developed in the 1950s by Singer, Prebisch, and Furtado, amongst others.

owned firms increased while that of group-affiliated firms decreased, resulting in a net loss of total firms. Unlike Brazil and Chile, half of the domestic business groups studied fared badly, 50% of which had previously expanded through privatizations in oil, electric energy, transport and infrastructure, steel and petrochemicals. Finally, one of the three domestic business groups that emerged over the period ceased to exist by 2003, adding to the elimination of two existing business groups (Table 2.1).

In a nutshell, the origin of many business groups in the three countries can be attributed to the market protection enjoyed by domestic firms under ISI policies between 1940 and 1970. Their larger participation in the economy since the 1980s and 1990s is a consequence of the privatization of SOE created under those ISI policies. Between 1990 and 2003, business groups in Brazil emerged and expanded due to privatizations and internationalization. Some were acquired by foreign capital. In Chile, the largest business groups expanded due to internationalization, privatizations, and mergers and acquisitions backed by foreign capital over the same period. In Argentina, many business groups that had grown due to privatizations, sold part or all of their assets since the late 1990s due to mergers and acquisitions mainly by foreign capital and because of financial distress.

Why did business groups follow such different paths across the three countries during 1990-2003? The following pages propose an explanation.

Table 2.1: Comparative Evolution of Business Groups in Brazil, Chile, and Argentina, 1990-2003

Number of business groups between brackets

	Brazil	Chile	Argentina
Growth	<u>Emergence</u> (8) privatization <u>Expansion</u> (16) privatizations (9) international (11) M&A (2)	<u>Emergence</u> (1) domestic market <u>Expansion</u> (19) international (19) privatizations (5) M&A (9) domestic market (4)	<u>Emergence</u> (3) domestic market <u>Expansion</u> (18) international (8) privatizations (15) M&A (5)
Contraction	<u>M&A</u> (7) by foreign capital (5) total acquisition by foreign (5) <u>Financial distress</u> (1)	N/A	<u>M&A</u> (8) by foreign capital (6) total acquisition by foreign (2) <u>Financial distress</u> (11) <u>Ceased to exist</u> (2)
Stylized Result	EMERGENCE & EXPANSION ACQUISITIONS BY FOREIGN CAPITAL	EXPANSION ACQUISITIONS BY FOREIGN CAPITAL	SHRINKING & ELIMINATION ACQUISITIONS BY FOREIGN CAPITAL
Privatizations	All domestic participants (17) fared well	All domestic business groups (20) fared well Many were participants (13) in privatizations	Half of the domestic participants (7) fared badly

Source: Author

3. Literature Review

There is a long tradition of business group analysis from a political economy perspective. It is worth beginning by referring to Gourevitch and Shinn whose recent work (2005) is based on the ‘varieties of capitalism’ approach (Hall and Soskice 2001). They argue that corporate forms are the result of particular public policies, which are due to particular political coalitions. Shareholders, managers, and workers are key players trying to build political coalitions inside and outside the firm to establish public policies that best favor their interests. The authors focus on public policies that affect the allocative mechanisms of the economy and protection of investors. According to the authors, if public policies privilege competition through the market and legal systems as allocative mechanisms (liberal market economy in terms of the ‘varieties of capitalism’ approach), we should expect widely held firms to be predominant. In this corporate form, ownership is distributed amongst external investors. One of the main things that make diffuse ownership possible, they argue, is the fact that the rights of minority shareholders are strongly protected through the legal system. And one of its main consequences is the conflict of interest between shareholders and managers. A board composed of directors representing shareholders monitors the managers of the corporation. On the other hand, if public policies privilege coordination through development of collaborative relationships and exchange of information inside networks as an allocative mechanism (coordinated market economy in terms of the ‘varieties of capitalism’ approach), we should expect business groups to be predominant. In this corporate form, control is concentrated in the hands of inside block-holders who monitor managers directly. The conflict of interest here is between controlling and minority shareholders. The authors argue that certain

political coalitions among or across management, owners, and workers encourage public policies that promote diffuse shareholding while others encourage policies that promote business groups. For example, workers will side with managers for employment protection, but will side with owners when pension fund systems make them stakeholders in a company. Further, political institutions influence the probability of one coalition defeating another. In other words, politics would shape the degrees of coordination, the rules that structure markets, and the extent of minority shareholder protection.

I believe this approach to be significant in the comparative study of corporate forms. I agree on the role played by political coalitions and institutions within the home state in influencing the public policies determining business outcomes. Moreover, I consider the importance of pension funds and financial intermediaries in shaping political preferences to be enlightening. However, their building blocks do not suffice to solve our puzzle. As mentioned in the previous chapter and in accordance with Morck's conclusions on business groups in Canada, the evolution of investor protection is a poor candidate to explain the evolution of business groups in Brazil, Chile, and Argentina during 1990-2003. To begin with, I have found no evidence on the evolution of minority shareholder rights, laws, law enforcement and performance of business groups in Brazil, Chile, and Argentina between 1990 and 2003 that supports the negative correlation between the evolution of investor protection and the evolution of business groups' performance. Furthermore, I find that the privileged mechanisms through which firms do business in Brazil, Chile, and Argentina do not fit inside the framework of either coordinated or liberal market economies, as pointed out by Schneider (2009, 4-5). Latin American economies, on the contrary, are characterized by hierarchical mechanisms

within business groups, foreign firms, and the labor market, that replace or attenuate the coordination or competition mechanisms found elsewhere. Finally, the theoretical framework developed by Gourevitch and Shinn does not pay much attention to the state whose role is significant when studying late developers (Schneider 2009, 24). Last but not least, their overall approach is static and not well suited to explaining change in public policies other than change in political coalitions. Therefore, changes caused by exogenous shocks, such as the international financial crisis of the late 1990s, cannot be fully captured within this theoretical framework.

There are, however, other studies in the literature on business groups that are more useful to our research. To begin with, there is consensus as to the origin of business groups. Most of them were family corporations close to and supported by the State (Khanna and Yafeh 2007, 352)⁸². Some scholars (Evans 1995; Woo-Cummings 1999) explain that ‘developmental states’ target some strategic industries to foster rapid economic development, encourage investment, and build up interdependent industries simultaneously. If this were *exclusively* led by business, development might be blocked due to capital constraints, hold-up problems⁸³, and spillovers between industries⁸⁴. If these were *exclusively* led by the State (Rosenstein-Rodan 1943), they might not result in successful development because investment decisions could be guided only by political

⁸² It is worth noting that some business groups emerged without state support. In developing countries, the emergence of these ones is often linked to international trade, hence, to foreign business and foreign states.

⁸³ An example of a hold-up problem: A might not be willing to engage in an agreement with B if A has to invest first then B, since B will have the bargaining power to ask more from the agreement once A has invested and risks to lose the entire investment if it does not accept B’s conditions.

⁸⁴ On a business-led big push, see Easterly (2001) on Japan in 1880 as a successful example.

concerns such as elections, thus compromising economic efficiency⁸⁵. A better option would be if the state were to delegate '*big push*' coordination to business groups (Morck 2010, 610-13). Because business groups are diversified, they operate in several industrial sectors. As a result of their control over several firms, they may subsidize some units through the profits of others. Due to their centralized control, they can coordinate investments and eliminate hold-up problems. Ultimately, competition among business groups may induce efficiency levels unattainable otherwise.

State support to business groups may include domestic market protection, export promotion, privatizations, tax exemptions, and cheap access to labor/ technology/capital. According to some authors, this last element is crucial during the different phases of development (Evans 1995)⁸⁶. Based on that premise, others prescribe that the state should organize financial markets, serve as investment banker (Gerschenkron 1962)⁸⁷ and induce more risk-taking business (Hirschman 1958)⁸⁸. Specific policies in this regard may include the channeling of funds from domestic (forced) savings towards business through state-related institutions; loans at subsidized interest rates; regulation or suasion of private banks to fund projects backed by the State (Lewis 1950; La Porta et al 2000) and the government's direct investment of equity in business groups' affiliated firms (Lazzarini and Musacchio 2010).

⁸⁵ On state-led big push, see Morck (2010) on Meiji Japan and postwar South Korea as examples of failures and on Singapore as the successful exception.

⁸⁶ "The willingness of state financial institutions to back industrial debt/equity ratios (...) was a critical ingredient in the expansion of new industries" (Evans 1995, 48).

⁸⁷ Although Gerschenkron considers the state as less efficient than the private sector in this role, he argues that state involvement in financial markets could solve the problem of late European developers where there was a disjunction between the scale of economic activity required for development (capital and technology) and the economic scope of the private sector.

⁸⁸ Hirschman argues that entrepreneurship is the key-missing element in Third World developers.

As mentioned in the previous chapter, the pyramidal structure is an interesting feature of business groups. If a controlling shareholder wants to operate its business at a larger scale, additional funds beyond its own capital are needed. However, the controlling shareholder of any firm risks losing control of the business whether financing with equity because it dilutes control or financing with debt because it raises the risk of bankruptcy. A pyramidal business group is a better alternative because it allows the controlling shareholder to lower bankruptcy risks by financing through equity from outside investors while securing its control of the business (Morck et al 2005, 674). This arrangement succeeds in shifting control power away from minority investors and towards blockholders (Shleifer and Vishny 1997; La Porta et al 1999, 16). Accordingly, the controlling shareholder can lift assets and income from lower to higher tier firms and dump liabilities and losses from higher to lower tier firms. This phenomenon is referred to as ‘tunneling’ or investor expropriation that can take enormous proportions (Morck et al 2005, 664; Chong and Lopez de Silanes 2007, xvii)⁸⁹. Moreover, some authors (Morck et al 2007, 123-124) argue that pyramidal business groups have an advantage in political rent seeking. Their longer horizons and capacity to repay favors for one firm with cash flow from another make them capable of cooperative behavior with the State and punishment of politicians who fail to deliver.

To wrap up:

- ISI policies were a major event that shaped relations between government and business groups between the 1940s and the 1970s. The state played a leading role in

⁸⁹ For a further discussion on tunneling, see previous chapter.

industrialization and delegated its coordination to business groups while providing them with financing.

- Market-oriented reforms were a major element that shaped the relations between government and business groups in the 1980s and 1990s. The state transferred state-owned firms to business groups and sometimes provided the latter with financing for the acquisition, the long run operation, and the internationalization of their business.
- Pyramidal business groups allow the controlling shareholder to finance with equity from outside investors without losing control of the business and keep bankruptcy risk low.

Pyramidal business groups in Brazil, Chile, and Argentina were at the center of market-oriented reforms between 1990 and 2003. Their operations became international and they participated in privatization, mergers and acquisitions. I think that their subsequent evolution was determined by the financing policies towards business that accompanied these market-oriented reforms. Thus, I will argue that state provision of equity-financing policies was a critical factor behind the corporate decisions that led to the different patterns of evolution of business groups observed across the three countries between 1990 and 2003. In the following section, I will show that *business groups fared well where equity-financing policies were available for them (Brazil and Chile) and badly where they were unavailable (Argentina)*.

4. Business Groups Financing Policies in Brazil, Chile, and Argentina, 1990-2003

In the following pages, I will assess the extent to which business groups had the opportunity to finance with equity by analyzing the financial system, the role of the state within it, and the financing options available for them in each of the three countries over 1990-2003. Then, I will show why equity financing was critical for business groups to fare well over the international financial crises of the late 1990s. Finally, I will show that business groups fared well in Brazil and Chile because the State provided equity-financing policies either directly (equity in public sector hands) or indirectly (equity in private pension funds hands) to business groups. This affected the governance structure of business groups, enabling them to finance with equity from domestic sources without losing corporate control while keeping the level of bankruptcy risk under control in face of negative external financial shocks. In contrast, business groups fared badly in Argentina because, already highly indebted in foreign currency, they were crowded out by the State from financial resources in the face of negative external financial shocks.

4.1. Business Groups' Financing in Brazil, Chile, and Argentina over 1990-2003

In Brazil, a large and concentrated banking sector⁹⁰ provided most of its funds through treasury securities to the Brazilian State, which owned the two largest commercial banks⁹¹; followed by three banks owned by domestic business groups⁹²; and by the foreign Santander Banespa Bank (Leal and Carvalho da Silva 2007, 216; Stallings

⁹⁰ By the end of the period under study, there were 149 universal banks, 27 commercial banks, 24 investment banks, and three development banks, in addition to the *Caixa Econômica Federal*. The ten largest held around 60% of the total assets of the system (World Bank 2005, 5).

⁹¹ *Banco do Brasil* and *Caixa Econômica Federal*.

⁹² Bradesco, Itaú, and Unibanco. Banco Bradesco has acquired the former state-owned *Banco do Estado do Maranhão* and launched a "Postal Bank" project in 2002 targeting at the large un-banked population in Brazil (World Bank 2005, 5).

2006, 233). Through its two main commercial banks, the state channeled funds to a variety of economic sectors⁹³. Through its development bank BNDES⁹⁴, the state channeled funds to business. The capital market, historically considered unimportant, increased its role as a provider of business financing since privatizations⁹⁵ (Chong and Lopez de Silanes 2007, 17, 216). Lastly, domestic private banking was never deeply involved in business financing while the role of foreign banks remained limited in the Brazilian banking sector (Leal and Carvalhal da Silva 2007, 216; Aldrichi and Postali 2010, 361-63). Hence, the main sources of long term business financing were the loans from BNDES and equity from BNDESPAR⁹⁶ and state-related pension funds⁹⁷ (Hochstetler and Montero 2013, 1487). BNDES' loans at subsidized interest rates⁹⁸ went to large and profitable firms constituting an average of 30% of their total loans by the end of the period under study, thus reducing their financial expenses in a significant way. The majority of these firms (88%) were not financed with equity by BNDESPAR. However, the majority of the firms (85%) financed with equity by BNDESPAR, did receive loans from BNDES (Lazzarini et al 2011, 6). This last situation was the one of many domestic business groups that participated in privatizations. Indeed, BNDESPAR holdings of

⁹³ *Banco do Brasil* plays a key role in financing agricultural production nationwide, focuses on export financing, credit to small enterprises, and improving access to credit by the low-income population. *Caixa Econômica Federal* is the largest institution for mortgages (World Bank 2005, 5).

⁹⁴ BNDES is a non deposit-taking institution, but it is by far the main provider of investment finance in Brazil. It has played a pivotal role in directed credit since its founding in 1951. "It currently provides around 60 percent of the country's long term finance ... BNDES lent nearly \$14 billion in 2004, which is far more than the Inter-American Development Bank lent in all of Latin America and approaches the amount that the World Bank lent in the entire world" (Stallings 2006, 233, 247).

⁹⁵ This change was coupled with legal reforms of corporate and securities laws (Chong and Lopez de Silanes 2007, 17, 216) and with the introduction of private certification of corporate governance standards in the stock exchange. The *São Paulo Stock Exchange* (BOVESPA) launched new listing segments, where firms engage to higher governance levels through voluntary contracts (Aldrichi and Postali 2010, 363).

⁹⁶ BNDESPAR is a subsidiary of BNDES.

⁹⁷ The Brazilian State held equity of large firms since the 1970s (Lazzarini et al 2011).

⁹⁸ The subsidized Federal Long Term Interest Rate (TJLP) was 7.5% points below the market rate (Lazzarini et al 2011, 6).

corporate equity were concentrated on business groups operating in electrical energy, oil and gas, mining, steel, paper and cellulose, as well as in telecommunications. A similar portfolio composition was the one of many state-related pension funds such as Previ, Petros, Funcef, Telos, Valia, and Sistel (Aldrighi and Postali 2010, 368).⁹⁹

In short, the Brazilian state channeled funds previously absorbed from the financial system to business groups, both financing their successful participations in privatizations and providing them with long-term financing under the form of *debt* and of *equity* over 1990-2003¹⁰⁰, as shown in Table 2.2.

In Chile, a few foreign and to a lesser extent domestic business groups controlled the majority of the financial institutions over the period studied; owning banks, pension and mutual funds, securities, and insurance companies (Lefort and Walker 2007, 391). The banking sector was composed of six foreign, nineteen private domestic, and one state-owned institution. Foreign banks held 40% of the assets and dominated commercial banking, mainly in the hands of Santander, BBVA, Scotiabank, and Citibank (World Bank 2004, 5). The most important private domestic banks belonged to domestic business groups: *Banco de Chile* (Luksic group), Bicecorp (Matte), Corpbanco (Saieh), BCI (Yarur), and Banco Penta owned by the homonym business group. The last three were specialized in financial businesses. Lastly, the *Banco del Estado de Chile* was the only state-owned institution (World Bank 2004, 5).¹⁰¹ The private pension funds were the main actors of the capital market that became relatively developed in regional terms after

⁹⁹ They held equity directly or through their investment funds 521 PAR and Litel (Aldrighi and Postali 2010, 368).

¹⁰⁰ For recent discussions on the rationale and institutional capacity of the Brazilian State in this regard, see Hochstetler and Montero (2013).

¹⁰¹ Other business groups owned financial institutions oriented to consumer credit such as Banco Paris (Paulmann), Banco Falabella (Solari-Cuneo-Del Rio), and Banco Ripley (Calderon).

20 years of operation¹⁰². Their portfolios included 40% of the bonds issued by the government. In despite of this and in contrast with Brazil, the state did not absorb many financial resources from the system. Its domestic debt was moderate and concentrated in Central Bank instruments (World Bank 2004, 3-5). Instead, the role it played within the financial sector was more of a regulatory one, performed through the Commission of Pension Fund Managers, the Commission on Banks and Financial Institutions, and the Securities and Insurance Commission. One of its most relevant regulations was the one separating financial from industrial business groups in the mid 1980s. Since then, business groups in Chile were unable to rely on lending from their own banks and had to operate their financial business independently from their other operations. Another relevant regulation was implemented in the 1990s when pension funds were authorized to invest in equity holdings (Lefort and Walker 2007, 292-3). By the end of the period under study, equity holdings from 90 listed firms represented 38% of their portfolios, which also included 40% of the bonds issued by corporations (World Bank 2004, 3-5). By the same time, all the existing pension funds but one were owned by foreign capital^{103/104} and all of them had held equity in business groups between 1990-2003. BBVA Provida and Cuprum invested in selected firms of 12 and 11 business groups respectively. Habitat, ING Santa Maria, and Bansander held equity in selected firms in 9, 9, and 8 business groups, respectively. Magister and Plan Vital invested in equity holdings of selected

¹⁰² It traded stocks equivalent to 85% of GDP in 2002 (World Bank. 2004, 3).

¹⁰³ Habitat pension fund was owned by the Citigroup; Magister and Planvital by the Bank of the Italian Switzerland; ING Santa Maria by ING; Bansander by Santander Bank, and Provida BBVA was jointly owned by Said group and the Spanish BBVA. The Chilean Penta group was the owner of Cuprum (*Federación Internacional de Fondos de Pensión*, several reports).

¹⁰⁴ The 3 largest pension funds managed 70% of pension assets. Their number dropped significantly from 21 in 1994 to 6 in 2003. By the end of 2003, pension fund assets reached 60% of GDP, a third of the total assets of domestic financial institutions (World Bank 2004, 5).

firms of 3 business groups each over 1990-2003, as shown in Appendix 2.1. Pension funds' holdings represented 10% of business groups' equity. Another 10% was in American Depositary Receipts and 6% was traded in the domestic market (World Bank 2004, 4-5,12).¹⁰⁵

In short, equity financing was available for business groups from pension funds mostly owned by foreign financial institutions structured as business groups in Chile. Debt financing through bonds and loans was also available to them from the same foreign institutions that dominated the financial sector in the country, as shown in Table 2.2. Regarding the state, it regulated the financial sector separating industrial from financial business groups, channeling domestic savings to the latter, and assuring long run financing to the former.

In Argentina, the financial sector was composed of private domestic, foreign, and public banks as well as an underdeveloped capital market¹⁰⁶ (Bebzuk 2007, 161). Among the most important private domestic banks, the oldest ones were Banco Frances and Banco de Galicia that operated exclusively in the financial sector. Yet, some domestic banks were part of the domestic business groups under study, and operated in industrial and retail sectors. This is the case of Banco Rio owned by Perez Companc, Banco Mercantil owned by Wertheim, as well as Banco Velox and Banco Roberts owned by the

¹⁰⁵ It is worth noting, "institutional investors do not all have the same incentives to monitor" how the funds they invest are used by (controlling) shareholders (Tirole 2006, 38). The incentive is linked to the structure of the business and the sources of institutional investors' profit. In 2004, the World Bank reported, "AFPs are by far the dominant institutional investors in (Chile). ... (They) have enjoyed persistently high profits (annual ROEs averaged 30 percent in recent years, twice that of banks), despite low levels of risk. While costs have declined and are becoming more comparable to those in OECD pension funds, there is scope for further reductions" advising for the reduction of commissions charged to their members (World Bank 2004, 13).

¹⁰⁶ The number of listed companies, domestic equity issues, and market capitalization was relatively low compared to other countries in the region (Bebzuk 2007, 161).

homonymous business groups¹⁰⁷ (Fracchia et al 2010, 327). Banco Galicia, Frances, and Rio were among the domestic institutions that provided financing to business groups for the acquisition of former SOE over the 1990s. Yet, the main focus of private domestic banks was retail and consumer lending (World Bank 1998, 10-12, 28). Among the foreign banks with the longest standing presence in the country, the most important were J.P. Morgan Bank, Citibank, and Deutsche Bank. New foreign institutions entered the market between 1990 and 2003, especially through the acquisition of domestic banks. Some of them quit the market in the early 2000s like *Credit Agricole*, Scotiabank, and *Banca Nazionale del Lavoro* while others remained like Santander, BBVA, and HSBC¹⁰⁸. Banco Bradesco and Banco Itaú, two of the largest private Brazilian banks, also existed in the country over the period studied (Galiani et al 2005, 86). In Argentina, foreign banks were mainly focused on mortgages and lending to public utilities companies and the industrial sector. Neither private domestic banks nor foreign banks lent significant amounts to the public sector. The latter depended more on public institutions that remained numerous despite privatizations¹⁰⁹ (World Bank 1998, 10-12, 28). Among the most important public banks were Banco Nación, *Banco de la Provincia de Buenos Aires*, and *Banco de la Ciudad de Buenos Aires*. In the mid 1990s, the government attempted to develop the capital market through the introduction of a private pension system that would coexist with the public pension one. Accordingly, financial

¹⁰⁷ As mentioned earlier, some of these banks (Banco Rio and Banco Mercantil) were acquired by foreign banks (Standander and Sudameris, respectively) while others (Banco Velox) went out of business over 1990-2003.

¹⁰⁸ BBVA and HSBC bought Banco Frances and Banco Roberts, respectively.

¹⁰⁹ Public provincial banks were 30 in 1994 and dropped to 20 in 1997. Private domestic banks dropped from 136 in 1994 to below 80 in 1997. Most of them were merged with other domestic banks or acquired by foreign ones. Few were closed. Foreign banks increased from 30 in 1994 to 40 in 1997 (Clarke et al 1999, 28).

institutions, insurance companies, and unions responded with the creation of private pension funds that managed the domestic savings of the population choosing the private pillar¹¹⁰. By 2000, six banks concentrated 85% of the members who belonged to banks both private and public. These were Consolidar (BBVA, Banco de Galicia and Banco Francés), Maxima (HSBC and Deutsche Bank), Siembra (Citicorp and Banco Río), Previnter (Bank Boston and AIG), Orígenes (Banco de la Provincia de Buenos Aires), and Nación (Banco Nación). Although equity financing was available, in principle, to the largest firms belonging to business groups through the domestic capital market and through American Deposit Receipts (World Bank 1998, 28), they seldom traded their capital publicly. Indeed, less than 40% of the business groups traded any of the stocks of their firms publicly by the end of the period under study (Fracchia, Mezquita, and Quiroga 2010, 328). Moreover, compared to Chile, access to equity financing through private pension funds in Argentina was very limited, even for business groups. Corporate equity represented 20% of the pension fund portfolio in Argentina as opposed to 38% in Chile, while the value of assets managed by them represented 3% of GDP in Argentina compared to 60% in Chile. Even business financing through corporate bonds represented 2% of pension fund portfolio in Argentina as opposed to 40% in Chile (World Bank 1998, 3-5, 28). In fact, half of the resources managed by pension funds in Argentina were invested in government bonds by 2000 (Rofman 2000, 47).

In short, business groups in Argentina mainly financed themselves through *debt* from foreign banks and to a lesser extent from private domestic banks over the period studied, as illustrated in Table 2.2. Like in Brazil, the state captured most domestic

¹¹⁰ Among the 25 firms that entered the system in 1994, 18 were operating at the end of 1997.

savings through public banks. Unlike Brazil, the state did not channel those funds to businesses either through a development bank or through public pension funds, but used them for its own funding. Like Chile, there was an attempt to channel public savings to business through private pension funds and to develop the capital market. Unlike Chile, the public pension system coexisted and competed with the capitalization system for domestic savings while its resources were managed by the State. Unlike Chile, two important pension funds operating under the capitalization system were owned by public banks.

Overall, I can say that domestic public savings were available for business financing in Brazil through the state under the form of *equity* and *debt*. Domestic public savings were available for business financing in Chile under the form of *equity* through private pension funds operating in the domestic capital market. In both cases, the source and form of business financing was reliable, sustainable, and used for at least two decades. Domestic public savings did not constitute an important, reliable, and long-standing source of financing for business in Argentina. So, in contrast to Brazil and Chile, business was mainly financed with loans from foreign sources. As Table 2.2 shows, there appears to be a positive correlation between the evolution of business groups and the existence of long standing equity financing policies.

Table 2. 2: The State in the Financial Market, Brazil, Chile, and Argentina, 1990-2003

Countries	Evolution of Business Groups (number & size)	The State in the Financial Market		
		Level of Domestic Resources Captured by the State	Public Policies towards Business Groups' Financing	
			Loans	Equity
Brazil	Emerged/expanded (+)	High	Yes	Yes
Chile	Expanded (+)	Low	No	Yes
Argentina	Shrank/Sold Out (-)	High	No	No

Source: Author

Why did long-standing equity financing in Brazil and Chile lead to the emergence and expansion of business groups between 1990 and 2003? Why did the absence of such policies make them shrink in Argentina over the same period?

In the following pages, I develop my argument by looking at the evolution of business groups financing in the three countries over the crisis of the late 1990s that began in East Asia and dried up the international financial market for developing countries.¹¹¹

In Brazil, half of the business groups studied were financed through equity from state related institutions, as shown in Table 2.3. This information was uncovered using the databases of Economatica containing information on public firms and capital markets in Brazil, Chile, and Argentina¹¹². All of the business groups that emerged over the

¹¹¹ For the political economy of the Asian crisis, see Haggard 2000.

¹¹² Economatica is a system for investment analysis composed of analytic tools and databases containing information on the the major economies of Latin America and of the United States. The system uses databases and information coming from primary data sources and official providers of information, such as *Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais* (ANBIMA), the Brazilian

period received equity financing from those institutions¹¹³. Among those that expanded, half was financed through equity held in the hands of state related institutions, while another 30% of them were successful in at least one privatization bid¹¹⁴. Thirty percent of those that evolved moderately and 25% of those that shrank were equity financed by state related institutions¹¹⁵. The state held 10% or more equity in Aracruz, Camargo Correa, Odebrecht and Usiminas and 20% or more in CPFL Energia, CSN Vicunha, Klabin, Neoenergia, Perdigao, and Vale, as shown in Table 2.3. These holdings were larger than what is considered minority holdings.¹¹⁶

Mercantile and Futures Exchange and the São Paulo Stock Exchange (BMF&BOVESPA), the *Comissão de Valores Mobiliários* (CVM), and similar organizations in the countries covered (www.economatica.com). Accessed March 2013.

¹¹³ Data on Embraer and Light was available beyond the period under study. Previ, BNDESPAR and Sistel held respectively 16%, 6% and 7% of equity of Embraer in 2006. BNDESPAR held 33% of equity in Light in 2007.

¹¹⁴ BNDES held equity in JBS Friboi since 2007, holding 13% that year.

¹¹⁵ Information was not available for four out of the eight business groups that shrank and were acquired by other corporations. However, in those cases where the business groups (Denerge and Norquisa/Copene) were acquired by other domestic business groups (Rede and Odebrecht), the buying corporations received equity financing from state related institutions. In the case of Belgo Mineira, Previ held 9% of equity of its Brazilian subsidiary Arcelor Brazil since the foreign company Arcelor Mittal acquired the business group. Lastly, foreign HSBC was authorized to acquire Bamerindus after state intervention in the latter.

¹¹⁶ It is worth noting, though, that these shares were not always voting ones. When considering only voting shares, state related institutions may achieve higher percentages of participation.

Table 2.3: Equity Holdings in Business Groups in Hands of the State in Brazil, 1998-2002

Business Group	Listed Firms	Business Group's Performance	Equity in Hands of State Related Institutions (%)						
			1990-2003	1998	1999	2000	2001	2002	2003
Andrade Gutierrez	A.Gutierrez Concessoes	expansion	no						
Antarctica	Antarctica	contraction	no						
Aracruz	Aracruz Celulose	moderate evolution	BNDES	12.6	12.6	12.6	12.6	12.6	12.6
Bamerindus	NA	contraction	NA						
Belgo Mineira	NA	contraction	NA						
Bradesco	Banco Bradesco	expansion	no						
Brasil Telecom	Brasil Telecom Par	emergence	Previ	5.4	NA	NA	5.4	5.2	NA
Camargo Correa	Sao Paulo Alpargatas	expansion	Previ	11.5	13.6	14.7	NA	14.7	14.7
CPFL Energia	CPFL Energia	emergence	Previ/BNDES	37.7	NA	NA	NA	38	NA
CR Almeida	Ecorodovias	expansion	no						
CSN - Vicunha	CSN	expansion	Previ/Valia/BNDES	33.2	30.4	29	10.3	12.1	NA
Denerge	NA	contraction	NA						
Embraer	Embraer	emergence	NA						
Gerdau	Gerdau SA	expansion	BNDES	3.6	3.5	1.7	2.4	2.4	3.9
Itamarati	NA	moderate evolution	NA						
Itausa	Banco Itau Holding	moderate evolution	no						
JBS Friboi	NA	expansion	NA						
Klabin	Klabin	moderate evolution	Previ/Petros/BNDES	NA	NA	53.3	0	0.1	0.1
Light	Light	emergence	NA						
Lojas Americanas	Lojas Americanas	moderate evolution	Previ	4.5	0.9	4.3	4.4	0	5.9
Mendes Junior	Mendes Junior	moderate evolution	no						
Neonergia	Coelba	emergence	Previ/521 Par	20	20		39.6	39.6	40
Norquisa / Copene	NA	contraction	NA						
Odebrecht	Braskem	expansion	Previ/Petros	11.7	11.7	11.7	11.7	NA	1.6
Oi	Telemar Norte Leste Par	emergence	Previ	5.7	NA	1	2.3	2.3	2.2
Pao de Acucar	Cia Br. Distribucao	moderate evolution	no						
Perdigao	BRF Foods	expansion	Previ /Valia/Sistel/BNDES	52.2	48.8	47.2	47.1	48	48.5
Real	Real Holding	contraction	Previ	10.5	0	0	0	NA	NA
Sadia	Sadia	expansion	no						
Santista	Santista Alimentos	contraction	Previ	11.9	10.7	11.2	NA	NA	NA
Sul America	Sul America	contraction	no						

Suzano	Suzano Papel	expansion	Previ	12.9	0	0	0	0	0
TAM	TAM	moderate evolution	no						
Ultra	Ultrapar	expansion	no						
Unibanco	Uniao Bancos Br	moderate evolution	no						
Usiminas	Usiminas	emergence	Previ	NA	12.5	12.5	12.5	12.5	12.5
Vale	Vale do Rio Doce	emergence	BNDES/Valepar/Litel	43.7	44.6	45.9	45.9	34.8	34.8
Votorantim	Cim Itau	expansion	no						

Source: Author based on Economatica Database, accessed on March 22nd 2013.

In 1998, the international financial crisis that had originated in East Asia hit Brazil¹¹⁷. The state responded with devaluation and fiscal adjustment. Between 1998 and 2002, during the years in which most of the policies against the crisis were implemented, state related institutions maintained equity financing for business groups on a selective basis. According to the information available from Economatica in Table 2.3, three business groups obtained an increase in equity financing from state related institutions (Neoenergia, Vale¹¹⁸, and Camargo Correa) and five preserved previous levels of equity financing (Aracruz, Brasil Telecom, CPFL Energia, Odebrecht, and Usiminas). Although two business groups suffered from a decrease in equity financing from state related institutions, equity holdings in state hands were maintained at 10% or higher (CSN Vicunha and Perdigao). Equity financing was erratic for three business groups (Gerdau, Lojas Americanas, and Oi), with a decrease on one or two occasions over that period but another increase by the end. Finally, four business groups suffered from reduction or elimination of equity financing from state related institutions (Klabin, Real, Santista, and Suzano). Overall, those business groups in which the state increased, maintained, or assured minimum levels of equity holdings over the years marked by the crisis, emerged, expanded or had a moderate evolution. Those in which equity holdings in public hands were erratic, reduced, or eliminated between 1998 and 2002, performed worse. The two

¹¹⁷ In the context of the Asian and Russian crises, Brazil suffered a speculative attack on its fixed exchange rate regime in the third quarter of 1998. In November the country received a preemptive US\$41.5 billion lifeline from the IMF and the U.S. Treasury, enabling Brazil to resist a forced devaluation of the real. However, in January 1999, continued massive selling of the currency forced the country to devalue and float the real. Following government fiscal adjustments although maintaining levels of financing to business and with a banking system not greatly involved in the crisis, consumer and investment confidence picked up. By May 1999, modest economic growth and net foreign capital inflows had returned (Armijo and Faucher 2004, 6; Stallings 2006, 228). The external shocks that hit Brazil caused significant policy changes and had an impact in term of economic growth. Yet, Brazil showed capacity to respond quickly and effectively.

¹¹⁸ The increase was between 1998 and 2001. Even if in 2003, there was a decrease, the equity holdings of the state in Vale reached almost 35% that year.

business groups that were initially financed through equity by the state but shrank over this period, suffered either a reduction or an elimination of equity financing during the crisis (Real and Santista).

While the Brazilian State implemented more selective equity financing policies regarding business, business groups searched for other sources of financing. Loans from public and private sources represented respectively 48% and 52% of credit towards business in the mid and late 1990s. However, their relative importance changed to 35% and 65% respectively in the early 2000s (Stallings 2006, 245). Despite this fact, domestic financing for business in the form of corporate bonds and, to a lesser extent, bank loans decreased from the beginning of the crisis, as shown in Table 2.4. In contrast, foreign credit towards business, both under the form of loans and bonds increased significantly. Among the most important recipients of the latter were Oi, Vale, and Votorantim business groups (Stallings 2006, 251). It is worth noting here that foreign financing to the public sector also increased between 1998 and 2002, although loans decreased and bonds increased significantly¹¹⁹.

Table 2.4: Other Sources of Business Financing in Brazil, 1994 - 2002

Source of Financing as Percentage of GDP in 1994 = 100

Year	Domestic		International		Total
	Loans	Bonds	Loans	Bonds	
1994	100	100	100	100	100
1998	99	102	129	213	104
1999	97	80	186	288	103
2000	97	63	177	263	96
2001	100	76	229	300	106
2002	95	68	220	288	100

Source: Author based on Stallings (2006)

¹¹⁹ International loans to the government represented 5.7%, 4.5%, and 3.8% of GDP in 1994, 1998, and 2002, respectively. Government bonds in international markets were 1.5%, 3.4%, and 12.9% of GDP in 1994, 1998 and 2002, respectively (Stallings 2006, 240-241).

To summarize, the state maintained equity financing to business selectively. Backed by this key support factor, business groups could share losses with domestic shareholders and retain control over corporate decisions due to their pyramidal structure. As their levels of bankruptcy risk were under control, they could access international financial markets and borrow from foreign sources in order to sustain them through the crisis. Having the state as (minority) partner, business groups that emerged because of privatization, and those that expanded over the 1990s, fared well over the period studied even if they faced negative external shocks of significant magnitude.

In Chile, seventy percent of selected firms belonging to the business groups under study were financed with equity held by pension funds over this period, as shown in Table 2.5, which is also derived from Economatica. All of them expanded. Among those that were not equity financed by pension funds, one was the Penta group the expanding financial business group owner of Cuprum pension fund¹²⁰. Some of the firms received equity financing from diverse pension funds like Entel (Fernandez Leon y Hurtado Vicuna groups); Almacenes Paris (Paulmann); SQM (Ponce); Copec (Angelini); Madeco (Luksic); and Empresas Navieras (Urenda).¹²¹

When the international crisis hit Chile in the late 1990s, the state responded with interest rate increases and international reserves reductions. Lending slowed. Yet, even if the capital market started to shrink after the crisis, the financial system was not disrupted by the shock (Stallings 2006, 146, 159-160).

¹²⁰ Another one was the Marin del Real group, an industrial business group that expanded over the period. There was no available data for the remaining business groups. Yet, Sigdo Koppers was equity financed by Provida since 2006 and Saieh emerged as a financial business group with Corpbanco over the period.

¹²¹ It is worth noting, however, that pension funds also held equity in firms belonging to foreign corporations such as Aguas Andinas (Agbar group), Iansa (Campos Chilenos group), CTC (Telefonica), Enersis (Endesa), and Santander Chile (Santander Bank).

Table 2.5: Equity Holdings in Business Groups in Hands of Pension Funds in Chile, 1998-2002

Business Group	Listed Firms	Business Group's Performance	Equity in Hands of Pension Funds					
			1998	1999	2000	2001	2002	2003
Angelini	Copec	expansion	3.4 (3 PF)	4.9 (4 PF)	5.5 (4 PF)	5.7 (4 PF)	6.6 (4 PF)	5.2 (2 PF)
Calderon	Ripley	moderate evolution						
CAP	Invercap	expansion	2.6 (1 PF)	2.6 (1 PF)	2.6 (1 PF)	1.3 (1 PF)	0	0
Claro	Elecmetal	expansion	0	3 (2 PF)	6 (2 PF)	1.5 (2 PF)	4.8 (1 PF)	3.7 (1 PF)
Fernandez Leon	Entel	expansion	0	0.3 (1 PF)	8.7 (4 PF)	4.4 (4 PF)	12 (7 PF)	21 (7 PF)
Hurtano Vicuna	Entel	expansion	0	0.3 (1 PF)	8.7 (4 PF)	4.4 (4 PF)	12 (7 PF)	21 (7 PF)
Ibanez	D&S	expansion						
Larrain Vial	CIC	expansion	0	0	0	0	0	0
Luksic	Madeco	expansion	0	4.5 (5 PF)	7.2 (5 PF)	10 (5 PF)	2.75 (2 PF)	2.9 (2 PF)
Marin Del Real	CGE	expansion						
Matte	Bicecorp	expansion	0	0	0	0	0.1 (1 PF)	0.2 (1 PF)
Paulmann	Almacenes Paris	expansion	0	0	2.1 (5 PF)	0	6.2 (6 PF)	21.2 (6 PF)
Penta	Penta	expansion						
Ponce	SQM	expansion	23.5 (7 PF)	26.8 (5 PF)	27.2 (6 PF)	9.1 (5 PF)	9.1 (5 PF)	11.25 (5 PF)
Said	Parque Arauco	expansion	0		3.6 (2 PF)	0	3.4 (1 PF)	3.8 (1 PF)
Saieh	Corp Group Banking	emergence						
Sigdo Koppers	Sigdo Koppers	expansion						
Solari-Cuneo-Del Rio	Falabella	expansion	0	0	0	0	1 (PF)	1 (PF)
Urenda	Empresas Navieras	expansion	12.5 (5 PF)	13.5 (5 PF)	13.4 (5 PF)	4 (5 PF)	4.5 (4 PF)	6.3 (4 PF)
Yarur	BCI	expansion	0	0	0	0	0	0

Source: Author based on Economatica, accessed March 22nd 2013.

Pension funds were the main providers of equity financing to business and maintained the value of their investments in corporate assets totaling 6.5 billion dollars over the crisis. However, their equity holdings decreased from more than 5 to less than 4 billion from 1998 to 2002 while their holdings in corporate bonds increased from 1 to 3 billions from 1998 to 2002, as shown in Table 2.6. Moreover, the relative importance of corporate assets in their portfolios decreased in order to privilege government bonds and assets of financial and foreign institutions (Stallings 2006, 160, 165).

Table 2.6: Portfolio Composition of Pension Funds in Chile 1998-2003

Billions of dollars

Period	Corporate Assets			Government	Financial Institutions	Foreign Institutions	Total
	Bonds		Total Corporate				
	Equity (*)	(*)					
1994	7.4	1.4	8.8	8.9	4.5	0.2	22.3
1995	7.9	1.6	9.4	10.0	5.9	0.1	25.4
1996	7.7	1.3	9.0	11.6	6.8	0.1	27.5
1997	8.0	0.9	8.9	12.2	9.3	0.4	30.8
1998	5.3	1.3	6.6	12.8	10.0	1.8	31.1
1999	4.8	1.5	6.3	11.9	11.6	4.6	34.5
2000	5.0	1.3	6.3	12.8	12.8	3.9	35.9
2001	4.2	2.3	6.5	12.4	11.7	4.7	35.4
2002	3.9	2.6	6.6	10.7	12.5	5.9	35.8
2003	7.9	3.9	11.8	12.2	13.4	11.7	49.2

Source: Author based on Stallings (2006) and FIAP (*Federación Internacional de Fondos de Pensión*)

(*) The amount attributed to equity and bonds in 1994 and 1995 was estimated according to their importance in 1996.

As shown in Table 2.6, equity financing to most of the selected firms belonging to business groups increased over 1998-2000, but followed a more selective and erratic evolution between 2001-2003¹²². Pension funds increased their equity holdings in nine business groups (Angelini, Claro, Fernandez Leon, Hurtado Vicuna, Luksic, Paulmann, Ponce, Said, and Urenda) and maintained their level of investment in one (CAP) over

¹²² The reasons behind this pension funds' strategy are out of the scope of this work. However, further research would be valuable in this regard.

1998-2000. Their placements in equity increased significantly in three business groups (Fernandez Leon, Hurtado Vicuna, and Paulmann), were more erratic in five cases (Angelini, Claro, Ponce, Said, and Urenda), and decreased in two other cases (CAP and Luksic) between 2001 and 2003. To wrap up, among the 14 business groups that were financed with equity over the period under study, ten continued to receive the same or higher level of equity financing over the first years of the financial crisis. Yet, pension funds became more selective in the level of equity holdings of these ten business groups since 2001, privileging some of them at the expense of others. Furthermore, pension funds did not hold equity any longer or their holdings became negligible in the four remaining cases (Larrain Vial, Matte, Solari/Cueno\Del Rio, and Yarur) since 1998. It is worth recalling here that the four latter were operating in financial businesses and pension funds increased other placements in those institutions at the expense of non-financial business over the crisis, as already mentioned above.

As pension funds were more selective in terms of their equity investments over the crisis, business groups turned to other sources of financing, in particular bonds in domestic and foreign markets, as a reaction to the crisis. Domestic and foreign financing for business in the form of corporate bonds increased significantly since 1998, as shown in Table 2.7. At the same time, foreign loans increased significantly in 1998 and in 2001 while the amount of domestic loans increased with the financial crisis maintaining its level over most of the subsequent years. Overall, the largest firms relied increasingly on external loans, bonds, and to a lesser extent, domestic loans as sources of financing by the end of the period studied (Lefort 2010, 404; World Bank 2004, 4).

Table 2.7: Other Sources of Business Financing in Chile, 1994 - 2002

Source of Financing as Percentage of GDP in 1994 = 100

Year	Domestic		International		Total
	Loans	Bonds	Loans	Bonds	
1994	100.0	100.0	100.0	100.0	100.0
1995	107.1	82.6	98.2	75.0	103.0
1996	97.3	67.4	127.7	362.5	104.5
1997	102.2	52.2	185.7	437.5	119.2
1998	107.9	63.0	213.4	500.0	130.4
1999	108.6	80.4	212.5	662.5	134.4
2000	107.4	110.9	189.3	650.0	131.2
2001	120.1	202.2	223.2	925.0	158.1
2002	109.8	250.0	222.3	1162.5	157.8
2003	101.5	287.0	200.9	987.5	148.2

Source: Author based on Stallings (2006)

To summarize, what I have argued is the following: pension funds selectively maintained equity financing to business groups. Backed by these key actors whose revenues depended on business groups' profits as well as on the commissions charged to their members, business groups could share losses with domestic shareholders retaining control over corporate decisions due to their pyramidal structure. With levels of bankruptcy risk under control and access to international markets, they could increase their borrowings from foreign sources over the crisis. Having foreign financial institutions as the central players of the domestic financial market, business groups that expanded over the 1990s fared well over the period studied even if they faced negative external shocks of significant magnitude.

In contrast with Brazil and Chile, there was neither a development bank nor a long-standing pension funds system in Argentina providing a significant and reliable flow of domestic resources for business financing in the form of equity. Instead, incipient pension funds reduced the participation of corporate equity in their portfolios considerably since the late 1990s, as Table 2.9 shows based on aggregated data.

Information available on listed firms does not include data about shareholders. Therefore, it was not possible to directly follow the evolution of pension funds' investments in corporate equity by firm and business group in the case of Argentina. Yet, we can see in Tables 2.8 and 2.9 that, in contrast with Brazil and Chile, business groups in Argentina mainly sought financing from foreign sources, either in the form of loans or corporate bonds. The stock of the external debt of the non-financial private sector was 4 billion dollars in 1991, 14 billion in 1994, and 37 billion in 1998. This last year, 75% of the debt corresponded to 59 firms belonging to business groups (Kulfas and Schorr 2003, 30), as Table 2.8 shows based on aggregated data. Information about the level of indebtedness of firms belonging to business groups in Argentina for the relevant period is scant. This is partly explained by the fact that more than 40% of the business groups had no firms that had opened their capital to the stock market (Fracchia et al 2010, 335). It is possible, however, to obtain from Economatica the ratio of the total debt over the total assets for Acindar, Aluar, Arcor, Astra, Disco (Banco Velox/Disco), IRSA, Ledesma, Loma Negra (Fortabat), Molinos (Bunge & Born then Perez Companc), and Siderar (Techint). The average level of indebtedness of these firms was 27% in 1990; 39% in 1994, and 50% in 1998.

Table 2.8: Stock of Private and Public Sector External Debt in Argentina, 1991-2001

Estimation of the debt stock in billions of dollars at the end of each year

Year	Business	Government	Financial Sector	Total
1991	4	53	5	61
1992	6	51	7	63
1993	10	54	9	72
1994	14	61	11	86
1995	18	67	14	99
1996	21	74	16	111
1997	30	75	21	125
1998	37	83	22	142
1999	37	85	24	145
2000	37	85	25	146
2001	35	88	17	140
2002	NA	NA	NA	NA
2003	NA	NA	NA	NA

Source: Kulfas and Schorr (2002)

The international financial crisis sent Argentina into a currency-growth-debt trap¹²³. The level of indebtedness in foreign currency of many business groups led many of them to oppose changes in the exchange rate policy, narrowing the margins for crisis resolution and delaying both decision and policy making. As some scholars asserted, “excessive (short-term) borrowing in dollars played a central role in triggering almost every emerging market financial crisis during the 1990s” (Litan et al 2003, 183). New foreign sources for business groups’ financing became virtually unavailable. Indeed, the stock of debt in international markets held by the non-financial private sector remained about at \$37 billion between 1998 and 2000, as shown in Table 2.8¹²⁴. Accordingly, highly indebted business groups began to sell their assets in the late 1990s, mostly to

¹²³ The currency became overvalued, growth stagnant and the public debt hard to service (De la Torre, Levy Yeyati and Schmukler 2003).

¹²⁴ A lot has been argued about the deviation of funds towards personal accounts that the business (and political) elite from Argentina have made with the credit obtained in international markets over these years (See Kulfas and Schorr 2002). The importance of this topic is undeniable. We could even ask why this happened (or happened in such extent) in Argentina compared to the other two countries? However, this topic is beyond the scope of the present study.

foreign firms, to remain liquid or invest in export-oriented activities (Kulfas and Schorr 2002, 36)¹²⁵. Moreover, pension funds over the crisis reduced drastically their investments in corporate assets in general and in equity in particular, from 24% and 22% in 1997 to 8% and 7% in 2002, respectively, as shown in Table 2.9. Even if this trend is also observed in Chile, pension funds in this country maintained levels of participation not lower than 18% in corporate assets in general and than 10% in equity over the crisis. Furthermore, the participation of government assets in pension funds' portfolios in Argentina increased constantly since 1997 reaching 78% in 2002. In contrast, pension funds in Chile decreased their investments in government assets in 1999, but maintained government participation in their portfolios in around 35% over the crisis. In other words, while pension funds in Chile reduced the participation of their investments in business and government alike over the crisis yet assuring them minimum levels of investment, the state crowded out business from the financial resources managed by pension funds in Argentina^{126 127}.

¹²⁵ Basualdo (2000; 2001) and Kulfas (2001), cited in Kulfas and Schorr (2002).

¹²⁶ This fact was already pointed out by other scholars, "in the period following the Asian crisis the government crowded out the private sector when a significant worsening in the financial conditions of the private sector was taking place" (Fanelli et al 2003) and "crowding out by the public sector have made credit constraints particularly acute for firms in Argentina since 2000" (Streb et al 2002).

¹²⁷ Unfortunately, information about the identity of the shareholders of listed firms is not available for Argentina. In contrast with Brazil and Chile, it was not possible to identify which pension funds held how much equity in which company in which year over 1990-2003.

Table 2.9: Pension Funds' Portfolios. Argentina and Chile, 1996 - 2003

Percentage

Period	Argentina			Chile		
	Private Sector		Public Sector	Private Sector		Public Sector
	Equity	Total		Equity	Total	
1996	19	27	54	28	33	39
1997	22	24	45	26	29	40
1998	19	21	51	17	21	41
1999	21	23	54	14	18	35
2000	11	15	56	14	18	36
2001	9	12	70	12	18	35
2002	7	8	78	11	18	30
2003	12	13	69	16	24	25

Source: Author based on FIAP (International Federation of Pension Funds Managers)

Although financial packages were received from the IMF in 2000 and 2001, Argentina experienced mounting capital outflows in late 2001. This resulted in deposit freezing¹²⁸, further default on the country's official foreign debt, devaluation, and floating of the peso in 2002 (Armijo and Faucher 2004, 7). This time, more business groups sold part or all of their assets or went bankrupt.

To summarize, despite the potential benefits of equity financing that lie behind their pyramidal structures, business groups in Argentina were financed with debt denominated in dollars from foreign sources for much of the period under study. Having initially limited access to domestic savings either in the form of equity and debt, business groups were crowded out from them by the state once the crisis hit the country. Having already high levels of bankruptcy risk, they could not borrow any more from foreign sources over those years. Many of them sold out or went bankrupt. Not having shareholders in the domestic financial market assuring them domestic financial support

¹²⁸ The name *corralito* (little fence in Spanish) for the deposit freeze was initially adopted because deposits could be used freely inside the financial system but could not leave the system. Several modifications to the *corralito* followed; for example, forcible reprogramming of time deposits.

during bad times, even business groups that expanded and became heavily indebted due to privatizations in the 1990s fared badly faced to the shocks produced by the international financial crises at the end of the same decade.

5. Conclusion

The purpose of this paper was to explain why business groups followed such different paths in Brazil, Chile, and Argentina during 1990-2003. As shown in Table 2.10, I found that equity-financing policies can explain the patterns observed. In Brazil and Chile where the state provided equity financing directly (through public institutions in Brazil) or indirectly (through foreign owned pension funds in Chile), business groups fared well. Indeed, equity financing policies affected the governance structure of business groups in these countries, enabling them to finance with equity from domestic sources without losing control on corporate decisions while keeping the level of bankruptcy risk under control in face of negative external financial shocks. In Argentina, pyramidal business groups, despite the potential benefits of equity financing, were mainly financed with foreign credit and fared badly. They were highly indebted in foreign currency and crowded out by the State from financial resources in face of negative external financial shocks.

This research also offers a corollary about the financial relations between business groups and the state in the period studied. In Brazil and Chile, business groups-state relations were mostly cooperative and their actions coordinated. In Argentina, business groups-government relations were at least unstable and contradictory with signs of competition, and the state was a rival of business in terms of financing over part of the period studied. Uncovering the reasons behind the nature of business groups-government relations is part of a future research agenda and is further developed in the Appendix 2.2.

Finally, this study raised other questions. Following Morck, it may be interesting to ask to what extent did the political rent seeking abilities of business groups in Brazil

and Chile explain their superior performance? What explains the differences between Brazil and Chile? To what extent does the fact that business financing was managed by a 'developmental state' in Brazil and by foreign financial institutions in Chile explain the emergence of new business groups in the former and the expansion of existing ones in the latter? Or in the words of other scholars (Litan et al 2003, 505), to what extent are domestic financial markets incubators for domestic business groups? Considering that the findings of the present paper correspond to the argument of other scholars about the link between debt-plus-equity financing and economic stability (Litan et al 2003, 509), to what extent did this type of business financing also resulted in economic growth and development in Brazil and Chile? Why were business groups in Argentina unable to build coalitions of shareholders to overcome the lack of equity financing, like their counterparts in Brazil and Chile? Following Gourevitch and Shinn, it is possible to ask to what extent the nature of political coalitions and institutions can explain the public policies towards business groups implemented in Argentina? These topics offer a variety of avenues for further research.

Table 2.10: Business Financing and Business Groups in Brazil, Chile, and Argentina, 1990-2003

Countries	Evolution of Business Groups (number & size)	The State in the Financial Market			Business Groups' Financing				Correlation consistent with hypothesis?
		Level of Domestic Resources Captured by the State	Public Policies towards Business Groups' Financing		Foreign	Domestic			
			Loans	Equity		Private		Public	
						Banks	Capital MKT		
Brazil	Emerged/expanded (+)	High	Yes	Yes	Low	Low	Low	High	YES
Chile	Expanded (+)	Low	No	Yes	High	Low	High	Low	YES
Argentina	Shrank/Sold Out (-)	High	No	No	High	Medium	Low	Low	YES

Source: Author based on Tables 2.1 to 2.9.

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Appendix 2.1: Chile. Business Groups' Equity in Hands of Pension Funds, 1990-2003

Business Group	Cuprum (Penta)	Habitat (Citigroup)	Magister (BSI)	Planvital (BSI)	BBVA Provida (Said - BBVA)	ING Sta Maria (ING)	Bansander Santander)
Angelini	x	x			x	x	x
Calderon							
CAP		x				x	
Claro	x	x			x		
Fernandez Leon	x	x	x	x	x	x	x
Hurtano Vicuna	x	x	x	x	x	x	x
Ibanez							
Larrain Vial	x						
Luksic	x	x			x	x	x
Marin Del Real							
Matte					x		
Paulmann	x	x		x	x	x	x
Penta							
Ponce	x	x	x		x	x	x
Said	x				x		x
Saieh							
Sigdo Koppers							
Solari-Cuneo-Del Rio					x		
Urenda	x	x			x	x	x
Yarur	x				x	x	

Source: Author based on Economatica, accessed March 22nd 2013.

Note: This information corresponds to the firms belonging to business groups selected for this study.

Appendix 2.2: Preliminary Ideas on a Research Topic

The Political Economy of Business-Government Relations in Argentina, 1990-2015

This research idea deals with the political economy of business-government relations in Argentina. In this paper, I concluded that they were contradictory and went from cozy to adversarial between 1990 and 2003. The aim of a new research is to understand the nature of these relations between 1990 and 2015. This period is of particular interest because the government was in the hands of the Peronist party, with the exception of twenty-four months between December 1999 and December 2001.

Theoretical Framework

The literature on autocratic economic systems offers a bureaucratic economy model (Wintrobe 1998) that can shed light on business-government relations in democracies that present remnants of authoritarianism. According to this model, autocratic systems can be thought of as large bureaucracies, which seldom behave according to command. A bureaucracy operating by formal rules would be too inefficient because of its rigidity. It would more likely operate in terms of exchange and competition. In order to increase efficiency, a superior within the bureaucracy would offer resources in exchange for a subordinate's extra effort. Trade between superiors and subordinates (vertical trust) increases organizational efficiency. Subordinates may collude among each other. Trade among subordinates (horizontal trust) decreases organizational efficiency. Bureaucratic exchange is based on trust networks rather than enforced property rights. The model assumes that an increase in vertical trust (T_v) produces an increase in bureaucratic efficiency. However, increases in bureaucratic efficiency due to vertical trust decrease in magnitude as long as vertical trust increases. The model also assumes that an increase in horizontal trust (T_h) produces a decrease in bureaucratic efficiency. As bureaucracy ages,

its members know each other better, so both T_v and T_h rise. Eventually, the efficiency loss from T_h outweighs the gain from T_v . Accordingly, this produces a cycle in efficiency levels that makes the bureaucracy follow productive and unproductive phases with a tendency to decline (Wintrobe 1998, 208-13).

When the model is applied to a modern political system, the autocrat at the top of the bureaucracy usually belongs to a party. The greater the power of the party, the greater its capacity to reward vertical trust and punish horizontal one, while demonstrating greater efficiency in terms of bureaucracy and output. The fundamental prediction of the model is that there is a positive correlation between the power of the party and economic performance in political autocracies. However, there is a problem with the economics of such a system. The condition for running any large bureaucracy efficiently is vertical loyalty, rather than horizontal solidarity that can be used to escape party control and tends to lower productivity. Hence, there is a contradiction between efficiency and equality/solidarity that becomes more apparent over time. In a single party state, this problem is particularly acute. There is no possibility of rejuvenation through the takeover of the state by a different party or by shifting functions of the state bureaucracy to the private sector (Wintrobe 1998, 228). In the absence of other institutionalized takeover mechanisms, certain systems react to their contradictions and decline with repression or reforms to break up horizontal networks (Wintrobe 1998, 216-7).

Research Objective and Question

The objective of this research is to assess the extent to which the bureaucratic economy model can explain the contradictory relations between business and government in Argentina from 1990 to 2015. The preliminary questions guiding the research are:

- Did the dominant party governing between 1990 and 2015 operate as a vertical network?
- Was there a bureaucratic efficiency cycle of productive/unproductive phases?
- How did the system react to decline?

The preliminary hypothesis is that the bureaucratic economy model can explain:

- Business discipline towards government (business participation in vertical networks)
- Lack of collective business action (government punishment of horizontal networks)
- Cozy business-government relations over productive phases (1990-96; 2003-11)
- Hostile business-government relations over unproductive phases (1997-99; 2012-15)

Contribution and Limits

Most of the research on business-government relations refers to consolidated democracies. Studies covering periods of democratic backsliding are still scarce. This study intends to bridge the gap. It also adds Latin American data to studies on the political economy of autocracies. We expect the model to better explain the Kirchner era than the Menem one, due to weaker opposition and a more closed economy in the 2000s.

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Essay 3. Legislative Control over the Bureaucracy as a Reflection of the Electoral and Party Systems: A Comparative Perspective on Brazil and Argentina

1. Introduction

Elected politicians rely on institutional controls to oversee bureaucrats after they have delegated their authority to them. This paper is about the role played by electoral and party systems in shaping these controls.

The topic of political delegation and control has been extensively studied, both in terms of theory and empirical analysis. Certain authors believe in the effectiveness of the methods politicians practice to control the bureaucracy. Others highlight the potential loopholes that allow bureaucrats to avoid scrutiny. Still others study the conditions that allow politicians to delegate authority to the bureaucracy without losing control under different political systems.

Studies in presidential systems largely focus on just one case: The United States. Due to the separation between legislative and executive powers, the U.S. Congress is equipped with its own controls to monitor the bureaucracy. The predominate view in the literature (discussed below) is that the U.S. Congress uses detailed administrative procedures contained in laws, the budget process, and the participation of interest groups to try to control the bureaucracy (McCubbins et al 1987).

Presidential systems take on diverse institutional forms in Latin America. Those of Argentina and Brazil have been modeled on the principle of separation of power of the U.S. system, but they have followed distinctive pathways since their constitutions were first developed. Authoritarian regimes in South America exercised complete control over all the branches of power until thirty years ago. Despite the third wave of democratization that began in the region in 1978 (Hagopian and Mainwaring 2005), these systems exhibit what may be called deficits in accountability (Cameron 2003; Mainwaring and Welna 2003; Power and Taylor 2011). Although one important aspect of the accountability

problem is legislative oversight of the bureaucracy, this issue is understudied both in theoretical and empirical terms (Pelizzo and Staphenurst 2012, 14-7).¹²⁹

The objective of this paper is to analyze the use of methods established to control the bureaucracy in Latin America using principal-agent theory. The paper focuses on the instruments in the hands of legislatures in the presidential systems of Argentina and Brazil. It compares the controls used in these countries with those used in the United States.¹³⁰ In particular, it evaluates the extent to which the Congress in Argentina and Brazil exercise autonomous legislative control of the bureau using instruments such as detailed administrative procedures written into laws, aspects of the budget process, and the participation of interest groups.

The study questions the usefulness of the U.S. model as a basis for explaining legislative control of the bureau in Brazil and Argentina. The analysis shows that both countries differ from the U.S. in how legislative control of the bureau is attempted and exercised because of the nature of their electoral and party systems.

Both South American countries have proportional representation electoral systems, which leads to multiple political parties. In Brazil, the lists of candidates up for election are open. This means that the number of votes received, instead of the decision of party leaders, determines candidate positions on a list. If candidates are elected to Congress, they have fewer obligations towards their parties and can negotiate their membership in multiparty coalitions, including the governing one. As long as the government coalition in Congress remains unchallenged, it assures a high level of discipline amongst the majority of legislators to the coalition and legislative support to the president. Thus, transitory

¹²⁹ According to Pelizzo and Staphenurst, the notion of legislative oversight is undertheorized. These same authors affirm that most studies on the topic examine legislative functions within countries more generally, and do not focus solely, or particularly, on oversight. They also mention that there is a plethora of studies on this issue in the United States, but only a relatively small number outside the United States (2012, 14-7).

¹³⁰ The focus on legislative controls in presidential systems allows for the isolation of the factors affecting control that are related to differences between parliamentary and presidential systems.

legislative coalitions in Congress intertwine the legislative and executive branches of power, in the presidential system of Brazil. As a result, legislative oversight over the bureaucracy is mainly in the hands of the government coalition in Congress and combines controls typically found in the U.S. presidential system with controls more common in parliamentary systems where branches of power are intertwined.

In Argentina, lists of candidates for elections are closed. This means that party leaders determine candidate positions on a list. Party leaders also control the career of elected politicians assigning them resources and political opportunities. Among the multiple political parties, the dominant Peronist party usually governs and often has a legislative majority in Congress. This allows party leaders of the dominant party to be assured of legislators' obedience in Congress and of their support to the president that tends to concentrate executive and legislative powers. This results in a form of legislative oversight over the bureaucracy responsive to the (Peronist) president and mainly composed of elements typically found in parliamentary systems.

The literature often presents differences in institutions compared to the U.S., such as those described above, as 'exceptions' or 'anomalies' in relation to the United States (Stapenhurst et al 2008). Part of the literature also argues that the 'exceptional' structures that emerge are conditioned by broader, systemic electoral and party forces (Mainwaring 1993; Cox and McCubbins 2001). It also suggests that control mechanisms that are designed for a separation of power system like that of the U.S. applied where powers are closer or concentrated amongst a few political actors, may jeopardize democratic accountability (Moreno et al 2003; Morgenstern and Manzetti 2003; Cheibub Figueredo 2003). In particular, Moreno et al (2003) study 18 countries of South and Central America using the the framework of the principal agent model and argue that the proper functioning of horizontal accountability (among state actors) depends on getting vertical accountability

(from elected officials to voters) right (2003, 82). Morgenstern and Manzetti (2003) study legislative oversight in Argentina with a focus on the budget process. They argue that these mechanisms have usually failed due to “the infrequent control of the Congress by the opposition, the economic crises, and the frequent military governments that suspended any attempts by the legislators to professionalize their institution and develop effective oversight mechanisms” as well as the inability or unwillingness of the Supreme Court to address abuses in this regard (2003, 135; 161). Cheibub Figueredo (2003) argues that although the role of Brazilian Congress is reduced as an agency of horizontal accountability, the legislature allows the flow of information to groups and individual citizens and, therefore, fosters the activation of other (social) mechanisms of accountability (2003, 191-2). Finally, Pelizzo and Stanpenhurst (2012) have applied the principal-agent model within a broader neo-institutionalist framework to study legislative oversight in presidential, semi-presidential, and parliamentary systems. In their studies (Stapenhurst et al 2008; Pelizzo and Stapenhurst 2012; 2014), they argue that the effectiveness of legislative oversight depends on the political will of legislative actors and that the media and the citizens can affect the political will of legislators.

In a general way, these arguments are complementary to that made here. The emphasis of this chapter is on the *structure of control mechanisms in Argentina and Brazil* and the explanation of the differences found across these two countries and does not attempt to assess the *degree* of accountability that results from the institutions observed.

To the best of our knowledge, the literature does not explore these matters in the depth that they are studied here. This comparative work on legislative oversight of the bureau, using principal-agent theory as a framework, stressing the role of different proportional representation electoral systems and multiparty systems in shaping controls,

and highlighting the role of the president and the governing coalition within these structures of control, appears to be original in the literature.

This paper proceeds as follows. The next two sections introduce the literature. Section four demonstrates how variations in electoral and party systems shape the degree of separation between legislative and executive branches of power in different presidential systems. Sections five and six present the legislative control methods used in Argentina and Brazil to oversee the bureaucracy, respectively. Section seven applies the main findings to the case of civil service in Brazil and Argentina. Section eight sets forth the conclusions.

2. Delegation of Political Authority to the Bureau and the Problem of Control

This section shows that delegation of authority generates the need for control. It reviews the literature on the causes behind political delegation of authority to the bureaucracy. Then, it reviews the conflicts that emerge between elected politicians and bureaucrats due to delegation, and the resulting need for the former to regain control over the latter.

Max Weber argues that the main reason behind delegation is knowledge. According to him, political leaders replaced occasional consultation to counselors by collegiate bodies of experts whose role was to resolve public issues by means of deliberation. With time, political leaders changed, but these collegiate bodies remained, due to their expertise (Weber, Gerth, and Mills 1948).

In modern democracies, elected politicians delegate some of their responsibilities to bureaucrats who have superior knowledge and experience on achieving public policy goals (Ripley and Franklin 1984, Egan 1998).

This topic has been discussed in political science and policy studies literature for a long time, and studied from the perspective of institutional economics over the last few decades. Regarding further causes behind political delegation, some scholars argue that delegating partial authority inside a specific institutional setting allows for a minimization of (transaction) costs (Axelrod 1984; Keohane 1984; Shepsle 1979; Weingast and Marshall 1988; Pollack 1997). Others view delegation as a means of distributing benefits to certain interest groups through bureaucratic institutions (Stigler 1971, Stetter 2000; Weingast and Marshall 1989). Another group understands delegation of political power as a way of avoiding the responsibility of decision-making. Politicians prefer to avoid unpopular decisions (Fiorina 1977; Arnold 1990; Epstein and O'Halloran 1999) or decisions whose costs are concentrated and benefits diffuse (Fiorina 1982). Still others argue that delegation represents a choice between two alternatives: the delegation of authority and decision making into the hands of bureaucrats (bureaucratic risk) or not, thereby assuming the risk of appearing in court due to their own decisions (legal risk) (Fiorina 1986).

Another group of scholars view the delegation of political authority as a means of determining institutional arrangements for decision-making. Such arrangements may include written proof of contract parameters, criteria for decision-making, and the designation of someone in charge of resolving issues under unforeseen circumstances. Pre-established institutional arrangements and delegation regulate relationships and distributional effects among different (political) actors in the face of unforeseen circumstances¹³¹ (Pollack 1997; Milgrom and Roberts 1992).

Others argue that delegation allows for regulation of the intrinsic instability of majority decision-making systems. As a voting mechanism, majority rule is intransitive. Accordingly, when confronted with several alternatives, these systems produce different

¹³¹ This perspective is related to the concept of 'incomplete contracts' (Williamson 1985).

outcomes, depending on the order in which the former are presented in terms of the vote. One way to solve this problem is to set an election agenda that establishes a specific voting order for different alternatives. In this sense, delegating agenda setting to a bureaucrat is a viable alternative, when there is consensus for change but no specific alternative to the *status quo* (McKelvey 1976; Riker 1980).

In addition, delegation of political authority has important consequences. It sets up a new distribution of power in policy making between politicians and bureaucrats, which can trigger the emergence of conflicts. If politicians and bureaucrats had the same preferences and objectives, delegation would seldom represent a problem. The former would trust the latter to act in the interests of politicians. However, politicians and bureaucrats often have different preferences and different objectives. The challenge for politicians is to draw on bureaucratic expertise, given that the latter may want to put it to different ends than the former (Putnam 1975; Peters 1981; Rourke 1984; Huber and Shipan 2009, 850-851).

This tension between democracy and bureaucracy mentioned by Weber^{132/133} highlights the political realm of bureaucracy that has led to more recent debates. Prior to the 1980s, the literature on bureaucracy highlighted ‘bureaucratic dominance’. The expansion of government involvement into new areas, along with increasing complexity of policy issues, have made it difficult for politicians to make some key policy decisions. In parallel, the growing professionalism and specialization of bureaucrats grants them the expertise and experience required to make these decisions and dominate policy making (Huber and Shipan 2009, 849). In this line of reasoning, some scholars have argued that bureaucrats behave inappropriately regarding policy making, by transforming the state into

¹³² “Under normal conditions, the power position of a fully developed bureaucracy is always overpowering. The political master finds himself in the position of the *dilettante* who stands opposite the expert, facing the trained official who stands within the management of administration” (Weber, Gerth, and Mills 1948).

¹³³ It is worth noting that Weber’s claim is related to all forms of modern government, not just democracy.

an elite organization rather than a democratic one. By answering to the elite, decision-making is moved from a public sphere to a private one, which may result in the state governed by bureaucrats or by interest groups that capture bureaucrats^{134/135}. Moreover, bureaucrats often have more means than their institutional opponents - executive and legislative power – not only because of expertise but also because of exclusive access to certain information and stability of duties (Miliband 1984; 1989; Lowi 1979).

Since the 1980s, scholars opposed to the ‘bureaucratic dominance’ perspective have intensively studied the topic. The principal-agent model has been applied to the relationship between the legislature that behaves as the principal on behalf of citizens and bureaucracy that acts as the agent¹³⁶ (Pelizzo and Staphenurst 2012, 15-17). Agents may put their interests before those of their principal, so a variety of controls are necessary in order to make them accountable, counteract such behavior, and align principal-agent interests (Rose-Ackerman 1978; Weingast and Moran 1983; Moe 1989). Hence, delegation requires analysis, not only of its benefits, but also of its costs for the principal, including transaction costs and contracts needed to control over the agent (Fukuyama 2004).¹³⁷

Underneath this approach lies the idea that an autonomous bureaucracy under political control is only possible provided certain accountability conditions are in place. Scholars have begun to study how rules may be designed for bureaucratic decision-making and political control of the bureaucracy. According to them, the division between administrative and political duties is possible if accountability mechanisms are properly

¹³⁴ For a summary of the debates on business interest groups and government, see Coen et al (2010).

¹³⁵ Bureaucratic dominance may also mean the illegal use of the state apparatus by bureaucrats against powerless citizens (i.e. unblocking or granting rights in exchange for bribes).

¹³⁶ Along the chain of political delegation in democracies, the ultimate principals are citizens and the ultimate agents are civil servants. Accordingly, the executive and the legislature can be principals or agents.

¹³⁷ The application of the principal-agent model to the public sector has been criticized. See Fukuyama (2004) and Meier and Hill (2005). However, some critiques have stimulated the development of specific controls that legislatures use to hold the executive and the bureaucracy accountable (Pelizzo and Staphenurst 2012). Others have been dissolved within models on bureaucracies (Niskanen 1968; Breton and Wintrobe 1982). For these reasons, this approach was considered useful and satisfactory for the purpose of this work.

used for correct institutions to govern decision-making (Weingast and Moran 1983; McCubbins, Noll and Weingast 1987; Kiewiet and McCubbins 1991; Moe 1989). These arguments have influenced the research agenda on bureaucratic control in presidential and parliamentary systems over the last decades.

It is worth acknowledging here that there is a conceptual disagreement among scholars regarding the activities and actors that should be included when addressing issues of accountability of public officials. The disagreement revolves around five areas: a) whether accountability refers to individuals' and organizations' being held up to public scrutiny regarding their performance; b) whether accountability is limited to cases of legal transgressions performed by state actors; c) whether accountability necessarily entails the capacity of the state to impose sanctions in cases of official malfeasance, in which case the institution of the ombudsman would be excluded; d) whether accountability is limited to principal-agent relationships, in which case the ombudsman and the judiciary would be excluded; and e) which actors serve as mechanisms for providing accountability (Mainwaring and Welna 2003, 9-17). As a result of the disagreements around these areas, the literature provides an array of concepts that go from broader to narrower notions of accountability.

This present work follows the more restricted concept of accountability in which the object of political accountability are state actors involved in principal-agent relationships (Moreno et al 2003). Here accountability is limited to formal authority to oversee and/or sanction (Moreno et al 2003; Kenney 2003). For this reason, this work does not include either an extensive study of the institution of the ombudsman nor an analysis of the judiciary, which is neither a principal nor an agent but rather an independent branch of

the state (Mainwaring and Welna 2003, 15).¹³⁸ So, this study approaches the issue within this framework and with the focus on the bureaucracy and the legislative and executive branches of government.

3. Legislative Control of the Bureau in Presidential and Parliamentary Systems

The way in which delegation of political authority and control over the bureaucracy are institutionally organized varies significantly across presidential and parliamentary systems (Moe and Caldwell 1994, 173). For this reason, this section reviews the literature on delegation and control in the presidential system of the United States and in parliamentary systems. The section will review how the type of democratic system is one of the most important factors affecting control over the bureau (Mainwaring 1993; Haggard and McCubbins 2001).

Indeed, the U.S. presidential system formally separates executive and legislative branches of power, making institutional relations between them transactional¹³⁹. As voters elect the president and legislators separately, the latter two have incentives to respond to the former. In the presidential system of the United States, legislators have incentives to be particularly responsive to organized groups of voters by pursuing specific interests, intervening quickly behind the scenes, in an *ad hoc* fashion to aid their constituencies¹⁴⁰ (McCubbins and Schwartz 1984).

Interest groups will pressure the legislature for bureaucratic choices that favor

¹³⁸ The role of the judiciary in matters of accountability and political corruption has an undeniable relevance. Yet, the study of the network of accountability institutions that operate within the three branches of government with support from autonomous institutions, NGOs, and the media (Power and Taylor 2011) is far beyond the scope of this work and requires a (systemic) approach broader than the one based on the principal-agent model used in this paper.

¹³⁹ For a cognitive perspective on the separation of powers system, see Cameron (2015).

¹⁴⁰ In the United States, legislators tend to pursue popularity and secure jobs (McCubbins and Schwartz 1984).

them¹⁴¹. Even if they succeed in structuring agencies for their own interest, opponent groups may gain control of the bureaucracy in the future. Interest groups also try to protect themselves against the president, who has the authority to act against their interests¹⁴². Due to this political uncertainty, interest groups try to influence the design of bureaucracy through legislators by means of legislative control mechanisms. This is their attempt to insulate the bureaucracy from democratic control on behalf of opponent groups and the president. This specific form of *ex ante* legislative control intends to narrow the discretion of bureaucrats with an array of detailed formal rules and requirements, such as objectives, decision criteria, and procedures. Interest groups tend to prefer a bureaucracy that is insulated against democratic control and buried in formal restrictions, despite any negative impact on effectiveness (Moe and Caldwell 1994, 174-6).

Due to the incentives they face¹⁴³, presidents are concerned about the performance and accountability of their administrations. Accordingly, they will try to shape a coordinated, unified, and central bureaucracy that they can control from above. Without going through the legislative process, they are able to reorganize administrative structures, impose rules, review decisions (Moe and Caldwell 1994, 175-6), and appoint bureaucrats.

As political authority is delegated to bureaucrats by the legislative and the executive in the U.S. presidential system, control is exercised over public officials by the legislative as well as by the executive. In other words, there are two distinct and separate principals behind delegation and control of the bureau, which is consistent with the checks and balances of a presidential system where the legislative and executive powers are separate and accountable to different constituencies. This has a corollary. There are

¹⁴¹ For a discussion on interest groups and the choice of institutional structure, see Moe (1989).

¹⁴² The president is more autonomous than legislators regarding interest groups due to the electoral system.

¹⁴³ In order to be judged successfully, presidents must be seen by the public as leading and governing effectively (Moe and Caldwell 1994, 175).

multiple veto points affecting bureaucratic activity, which in turn protect the *status quo*. Whatever *ex ante* control is formalized in the law tends to persist and new law making becomes difficult (Moe and Caldwell 1994, 177).

In parliamentary systems, the legislative and executive branches of power are intermingled¹⁴⁴. The government arises from the majority party (or coalition) in parliament. The leader of the majority in parliament is the leader of the legislature and becomes the leader of the executive branch. Furthermore, the legislature gives rise to the rest of the cabinet. Both branches of power are controlled by the majority party (or coalition) and have a hierarchical relationship (Moe and Caldwell 1994, 175).¹⁴⁵ Accordingly, the government can usually pass its program very conveniently. It can also withdraw anytime from any political deal, and interest groups are aware of this. Despite the fact that parties and interest groups benefit from durable deals that exchange government largesse for political support, government promises may lack credibility. Furthermore, should another party gain majority status, it can pass its program and destroy whatever was previously put in place. By concentrating all the power inside the governing party, parliamentary systems tend to create a commitment problem (Moe and Caldwell 1994, 177).¹⁴⁶

Unlike the U.S. presidential system, there is no *ex ante* mechanism embedded in the law, capable of insulating the bureaucracy from future authorities. Formalization does not work as protection against monopoly of public authority by the governing party. Therefore, the bureaucracy is usually less constrained by external and formal rules and

¹⁴⁴ In parliamentary systems, there is greater fusion of the two branches of power, but it is misleading to conclude that there is no separation of legislature and executive (Von Mettenheim 1997).

¹⁴⁵ For a study on Canada, see Donald Savoie (1999; 2003).

¹⁴⁶ The most obvious way to solve commitment problems is either by introducing constitutional changes to the pure Westminster model (a powerful second house of parliament, an independent judiciary, federalism) that divide and internally check government authority or by means of norms and reputation, and cooptation (Moe and Caldwell 1994, 179).

struggle over its design and control between the legislative and executive branches is rare.

Thus, the governing party delegates considerable discretion to bureaucrats in parliamentary systems and controls them through a simple, coherent, rational, and centrally designed hierarchy of administration (Moe and Caldwell 1994, 178) mainly by means of *ex post* controls (Stapenhurst et al 2008, 15). In other words, there is one principal behind delegation and control of the bureau, composed of elected politicians from the governing party in legislative and executive positions. This is consistent with the need for control in parliamentary systems, where branches of power are intertwined and elected politicians remain accountable to their respective constituencies, whether or not they hold a legislative or executive position in government.

In short, the degree of separation between legislative and executive branches of power determines the nature of the principal agent problem: two principals in the United States, but one only in parliamentary systems, as shown in Figure 3.1. As the principal agent problem determines the need for control, differences are expected between specific oversight tools used in the United States and those used in parliamentary systems.

Source: Author

The legislative control available in presidential and parliamentary systems is established by constitutional provisions, institutional arrangements between branches of power, and division of authority among different levels of government (Dubrow 1999). As recorded in Table 3.1, legislative oversight tools vary in terms of the unit in charge of control, their timing, and the extent to which their use is predominant in presidential and parliamentary systems. (A more detailed explanation about legislative control over the bureaucracy in the United States is developed in the Appendix 3.1). They include reports, institutional design, sanctions, and decisions on budget allocations. They can be in charge of units internal or external to the legislature.¹⁴⁷ *Ex ante* control can take place before the commitment of government or during policy formulation, allowing politicians to set the level of bureaucratic discretion in advance. Ongoing control allows for monitoring agencies during bureaucratic work. Control that takes place *ex post* grants politicians the choice to audit and check whether policy has been implemented according to their intentions (Stapenhurst et al 2008, 15; Huber and Shipan 2009, 849).¹⁴⁸

Ex ante control includes legislation and confirmation of executive appointments as well as budgetary decisions that can also be taken while the budget process is taking place. The legislation determines the objectives, criteria, and specific tasks that bureaucrats should follow and perform. The language used to formulate the laws can be general or specific. The more specific the language, the more detailed the administrative procedures and the lower the level of discretion in policy administration granted to bureaucrats (McCubbins et al 1987; McCubbins and Schwartz 1984). As already mentioned, the language used in the laws tends to be specific to grant less bureaucratic discretion in the U.S. presidential system, and broad to allow greater bureaucratic initiative in parliamentary

¹⁴⁷ In legislatures, there are informal institutions that may perform oversight activities like caucuses (Lowi, Ginsberg and Shepsle, 2006). On informal institutions in Latin America, see Helmke and Levitsky (2006).

¹⁴⁸ For other classifications of controls, see Stapenhurst et al (2008, 30).

systems. U.S. legislators use detailed legal procedures to prevent the president from using the bureau against the interests of Congress and its constituencies. Legislator concerns as to how the executive uses bureaucracy are lower in parliamentary systems, because the executive depends on a legislative majority from its own party. Therefore, legal procedures tend to be simple, broad, and non-binding in parliamentary systems (Huber and Shipan 2002, 31-32; Eaton 2003, 41-42).

As a form of control, the confirmation of executive appointments allows the Senate to reject candidates nominated by the executive to high ranking positions (Lemos and Llanos 2006). It is a tool more common in presidential systems than in parliamentary systems where higher ranking positions are mostly filled with career civil servants (Spiller and Urbiztondo 1994).

The formulation and approval of the budget as well as the allocation of expenses are opportunities for *ex ante* and ongoing control. In presidential systems, the legislature tends to play a more significant role in controlling the budget process at early stages than those in parliamentary systems, through the work of committees in budget formulation and approval (Wehner 2005). As shown in Table 3.1, financial reporting and auditing represent opportunities within the budget process for *ex post* control (Stapenhurst et al 2008, 52). Certain legislatures constitute special committees to audit public accounts. Until recently, this tool has been an exclusive feature of parliamentary systems (Pelizzo and Stapenhurst, 2004). In these systems, supreme audit institutions also have a long tradition. They are external organizations that review financial, legal, and performance indicators linked to public accounts¹⁴⁹. Their reports are presented for the consideration of their legislature that often appoints the auditor general and approves of their budget (Stapenhurst et al 2008).¹⁵⁰

¹⁴⁹ For a discussion on models of external audit institutions, see Stapenhurst and Titsworth (2001).

¹⁵⁰ Legislative influence over the budget is affected by political majorities (Leston-Bandeira 1999).

Table 3.1: Legislative Control of the Bureau in Presidential and Parliamentary Systems

Type of Control	Unit in charge of Control	U.S. Presidential System	Parliamentary System
<i>Ex ante / On going</i>			
Legislation	Committees/Houses	Main	NO
Budget Process	Committees/Houses	Main	NO
Confirmation of Executive Appointments	Senate	Secondary	NO
<i>Ex post</i>			
<i>Investigative</i>			
External Budget Auditing	Supreme Audit Institution	Secondary	Main
Hearings	Committees	NO	Main
Interrogations	Houses	NO	Secondary
Interpellations	Houses	NO	Secondary
Inquiries	Committees	Secondary	NO
External Investigations	Ombudsman	NO	Secondary
<i>Sanctions against the Executive</i>			
Non-confidence vote	Houses	NO	Secondary
Impeachment	Houses	Exceptional	NO

Source: Author

Ex post tools also include investigative control and sanctions against the executive. Legislative committees have the authority to investigate issues linked to their area of work regularly and report these hearings to the legislature. Committees can also establish special commissions of enquiry, which can summon witnesses to testify under oath, demand documents, and order inspections. Committee hearings are frequent in parliamentary systems while commissions of enquiry are more common in presidential ones (Pelizzo and Stapenhurst 2004). The houses are entitled to carry out interrogations and interpellations.¹⁵¹ The first tool allows for obtaining information, exposing abuses, and making ministers accountable to the legislature. The second one is designed to provoke comprehensive debate on a particular issue of ministerial neglect and may lead to a motion demanding that the minister resign. Both procedures are common in parliamentary systems (Stapenhurst et al 2008, 15). Ombudsman offices can also carry out inquiries on bureaucratic activity. These offices investigate public agencies at the request of the legislature in certain countries and are more frequent in parliamentary systems (Pelizzo and Stapenhurst 2012, 28-30). In fact, there is no federal ombudsman office in the sphere of Congress within the U.S. presidential system (Adcock 2014).

Finally, legislatures have the authority to remove officials after their appointment. One way to remove ministers, for example, is by means of a vote of non-confidence indicating a loss of political support for the executive. A vote on budget disapproval may mean the loss of a confidence vote and lead to the resignation of the executive. This mechanism is common in parliamentary systems. Another way to remove officials from office is by impeachment. This is a last resort procedure usually used in presidential systems when highly ranked officials are suspected of illegal actions towards the government (Stapenhurst et al 2008, 55; Pelizzo and Stapenhurst 2012, 35-40).

¹⁵¹ Interpellation is common in parliamentary and semi-presidential systems. It is not found in the United States (Pelizzo and Stapenhurst 2012).

To summarize, separation between legislative and executive branches of power in the U.S. presidential system makes powerful actors out of interest groups. As privileged constituencies of legislators, they can influence and participate in the legislative procedures that control the bureau and make it work in their interest. As shown in Table 3.1, this results in a system of legislative control over the bureaucracy based on two main pillars in succession, along with the participation of interest groups. These pillars consist in detailed legislation that reduces bureaucratic discretion *ex ante*, followed by budget control that reward and sanction bureaucratic activity ongoing and *ex post*. This structure is complemented by secondary control methods such as confirmation of appointments, commissions of enquiry, and external audits as well as by impeachment in exceptional situations. This system of control over the bureaucracy responds to the legislature and is autonomous from the executive.

Fusion of power in a parliamentary system turns the majority party into the most powerful actor, due to its unchallenged hold on government power.¹⁵² Policy preferences of legislators tend to be similar to those of ministers. The majority party controls the administration centrally and *ex post*. The preference for *ex post* controls makes agencies work with important levels of discretion that do not constrain the benefits of bureaucratic expertise in advance. As recorded in Table 3.1, *ex post* budget control, such as public account committees and external auditing institutions, is preferred in parliamentary systems. Investigative controls are frequently used, such as hearings, and to a lesser extent interrogations and interpellations. The minority party may make use of control with political intentions over the administration, particularly the non-confidence votes against the executive. The choice of legislative tools to oversee the bureaucracy in parliamentary systems reflects the initial confidence of the parliament towards the executive, as well as

¹⁵² Indeed, the majority party in a parliamentary system is more powerful than the president in a system highlighting division of power (Moe and Caldwell 1994, 179).

the need for the former to make the latter accountable.

The remaining sections will discuss legislative oversight in Argentina and Brazil. The topic has been largely researched in relation to developing countries in recent years.

Many of these countries count on an array of mechanisms for legislative oversight. However, scholars of democratic accountability in these countries have acknowledged that mechanisms that work in one country may not work (similarly) elsewhere and controls appropriate for parliamentary systems may be inappropriate in (semi) presidential systems (Pelizzo and Stapanhurst 2014, 2-3). Moreover, there is empirical evidence (Balde 2009; Coulibaly 2006; Ebo and N'Diaye 2008) to claim that the mere existence of controls does not mean that they will be used or used effectively (Mainwaring and Welna 2003, 24-28; Pelizzo and Stapanhurst 2014, 97-100; Power and Taylor 2011, 15).

Some authors argue that if there is no political will to perform oversight activities in developing countries, legislative oversight will not be performed effectively. These authors affirm that the presence or absence of political will reflects the structure of incentives confronting legislators, which is shaped by voters' demands and the press. According to them, the interplay between voters' demands, the press, and politicians' strategic considerations explains why oversight capacity is or is not used effectively in developing countries (Pelizzo and Stapanhurst 2012, 107-116; 2014, 100-103).

The following sections propose another explanation: the use of legislative oversight over the bureaucracy in the presidential systems of Argentina and Brazil is affected by electoral and party systems in general and by multipartism and multiple party coalitions in government in particular.

4. Elections, Political Parties, and Legislatures in Brazil and Argentina

The previous sections have presented a review of the literature on delegation of political authority and the problem of control over the bureaucracy in presidential and parliamentary systems. It was demonstrated that the different degree of separation between legislative and executive powers originated in the differences between presidential and parliamentary systems conditions the nature of the principal-agent problem that comes with delegation. Accordingly, the institutions and instruments to control the bureau are different in each case.

However, factors other than the differences between presidential and parliamentary systems may influence the degree of separation between legislative and executive powers. One of those factors is linked to the electoral and party systems. Differences in the way the electoral and party systems work affect legislators' behavior within Congress (Haggard and McCubbins 2001, 539). Different behavior in Congress determines different degrees of separation between powers across presidential systems, affecting the principal-agent problem and the control over the bureau.

The following pages review the main features of the presidential systems of Argentina, Brazil, and the United States. The U.S. case serves as foil for the analysis of the two other countries and is explained in more detail in Appendix 3.1. The core aspects of the electoral systems, the role of political parties within legislatures, and the legislative powers of the presidents are summarized in Table 3.2. The table also shows that the degree of separation between legislative and executive branches of power in both South American countries is narrower than in the U.S. presidential system.

Table 3.2: Electoral Systems, Political Parties, and Legislatures: U.S., Argentina, and Brazil

	United States	Argentina	Brazil
Electoral System			
	PLURALITY/MAJORITY	PROPORTIONAL REPRESENTATION Closed Lists	PROPORTIONAL REPRESENTATION Open Lists
Party System			
	BIPARTISM	MULTIPARTY One dominant party	MULTIPARTY Government Coalition
Parties in the Legislature			
Party Leaders	Distance from President	Negotiators of President	Coalition Negotiators with the President
Party Discipline	LOW	HIGH (Dominant Party)	HIGH (Government Coalition)
Legislative Powers of the Executive			
Initiative	No	Yes	Yes
Veto	Total	Total + Item	Total + Item
Use of Decrees	No	Yes	Yes
Legislators in Cabinet	No	Yes	Yes
Penetration of the Executive in Congress	LOW	HIGH	HIGH
DEGREE OF SEPARATION OF POWERS	HIGH	LOW	LOW

Source: Author

The presidential system of the United States is based on two political parties and grounded on the premise that separation of power establishes checks and balances between branches of government (Cameron 2003).¹⁵³ The possibility that one party can win the executive power and the other one Congress, thus transferring electoral competition to political institutions, reinforces this premise, which becomes evident in control over the bureaucracy. In the United States, legislative oversight regarding the bureaucracy is a system responsive to Congress and autonomous from the executive. In other words, delegation of legislative authority by Congress (the principal) to the bureaucracy (the agent) is controlled by the legislature. The principal delegates unto and controls the agent.

As elsewhere in the region, Argentina and Brazil mirror the U.S. constitution. They possess presidential systems with separation of powers, replicating institutional structures and functions like those found in the United States. Besides the separation of powers, there must be the 'separation of purpose' in order that the different parts of the government are motivated to seek different goals. Otherwise, the system of checks established by the separation of powers can be disabled (Haggard and McCubbins 2001, 2).

Despite convergence to the U.S. model, institutional processes and structures do not necessarily follow the same trajectory nor generate the same results everywhere (Dimaggio and Powell 1983). There are important differences between the two South American systems and between them and their model.¹⁵⁴ As shown in Table 3.2, the presidential system of the United States is grounded on a plurality electoral system and a two party system.¹⁵⁵ The electoral systems in Argentina and Brazil are ruled by

¹⁵³ As well as strong legislative committees and the independence of the judicial power.

¹⁵⁴ According to some authors, these differences can be explained by pre-existent - political, economic, or social - conditions leading to path dependences difficult to reverse (March and Olsen 2006; Streek and Thelen 2005).

¹⁵⁵ In the United States, elections are ruled by a plurality system in which each voter is allowed to vote for only one candidate. The candidate who polls more votes than any other candidate is elected to the legislature.

proportional representation. This means that seats are allocated in proportion to the votes that parties receive in each district, where two or more candidates are elected to the legislature. A typical result of these systems is the emergence of multiple political parties (Duverger 1951).^{156/157}

Since the return of democracy, the party system in Argentina has gradually shifted to a multiparty one with one dominant party (Cardoso and Graeff 2012, 29). Historically, two catchall parties used to form the party system in this country: the *Union Cívica Radical* (Radicalists) and the *Partido Justicialista* (Peronists).¹⁵⁸ Military rule constantly interrupted the democratic order from 1930 until 1983. Democracy returned with Radicalist President Raúl Alfonsín, who ruled from 1983 to 1989. The Peronists under President Carlos Menem governed from 1989 to 1999. A coalition of Radicalists and former Peronists governed under Radicalist President Fernando De la Rúa from 1999 to 2001. In December 2001, President De la Rúa resigned in the middle of an economic, social, and political crisis. This severely weakened his party (Stein and Tommasi 2008, 83). Since then, Peronists have governed under President Eduardo Duhalde from 2001 to 2003, under President Néstor Kirchner from 2003 to 2007, and under President Cristina Fernández de Kirchner from 2007 to 2015. Over certain periods, for example between 2011 and 2015, the governing party has controlled both houses of Congress. Except for the

These rules favor bigger parties and discourage smaller ones, promoting the emergence of a two party system (Duverger 1951).

¹⁵⁶ On electoral systems and political parties, see Duverger (1951) and also Lijphart and Grofman (1984), Horowitz (1990), and Cox (1997).

¹⁵⁷ Military and authoritarian legacies may have influenced the choice of electoral and party systems that concentrate power and prevented the development of civil society. Despite the relevance of the topic for the region, it is beyond the scope of this paper.

¹⁵⁸ The former emerged in the 1890s to challenge oligarchic rule. Its socioeconomic base was a middle class with immigration origins. It first captured the presidency in 1916. The latter emerged in the 1940s under Juan Domingo Perón, who was president from 1946 to 1955 and from 1973 until his death in 1974. Its socioeconomic base is a metropolitan coalition with a core in the urban working class and a peripheral coalition of provincial groups (Stein and Tommasi 2008, 82).

24 months of De la Rúa *interregno*, the Peronists have been at the head of the state for the last 25 years until recently.^{159/ 160}

In Brazil, the multiparty system has been a historical feature.¹⁶¹ The military constantly interrupted the democratic order since 1930¹⁶² and re-instituted the multiparty system before leaving power in 1985 (Skidmore et al 2010). Since then, few parties have dominated the scene. The *Partido do Movimento Democrático Brasileiro* (PMDB) governed between 1985 and 1990 under President José Sarney, and between 1992 and 1995 under President Itamar Franco¹⁶³. The *Partido da Social Democracia Brasileira* (PSBD) led by President Fernando Henrique Cardoso ruled between 1995 and 2002. The *Partido dos Trabalhadores* (PT) has been in power since 2003, led first by President Luiz Inácio Lula da Silva and currently by President Dilma Roussef. These parties have attracted almost thirty parties active in Brazil around them for the purpose of political alliances and government coalitions. In effect, the Brazilian president is usually backed by a coalition of multiple parties and can govern as long as he/she maintains the legislative support of the members of his/her coalition. A recent illustration of this feature is the loss of support suffered by the government of President Roussef when the PMDB abandoned

¹⁵⁹ Until recently, third parties have achieved some prominence, but their force had rarely lasted beyond five years. Their failure had been associated to their inability to build a territorial reach in a country where national and provincial politics are strongly related (Stein and Tommasi 1998, 83). In December 2015, a coalition called *Cambiamos* won the presidential elections. The main party of this coalition is called *Propuesta Republicana* (PRO) and is neither Peronist nor Radicalist. It is a new right wing political party with former Peronist members. The Radicalists are part of the *Cambiamos* coalition. Although beyond the scope of the present work, the emergence of new political configurations is an interesting avenue for further research.

¹⁶⁰ On the new government, see <http://www.lanacion.com.ar/mauricio-macri-presidente-t55365>.

¹⁶¹ Political parties were forbidden between 1937 and 1945 under Vargas. In 1945, Vargas re-democratized Brazil and reinstituted a multiparty system with three main parties: Vargas' *Partido Trabalhista Brasileiro*; the *Partido Social Democrático*; and the *União Democrática Nacional*. In 1964, the military forbade parties again and in 1966 instituted a bi-partisan system with the pro regime *Aliança Libertadora Nacional* and the authorized opposition *Movimento Democrático Brasileiro*.

¹⁶² In fact, the *coup* in 1930 put an end to the 'Old Republic' (1889-1930) and initiated the 'Vargas Era' (1930-1945) that was followed by the 'New Republic'. This one was interrupted between 1964 and 1985 (Skidmore et al 2010).

¹⁶³ Yet, Franco achieved the Presidency with *Partido de Reconstrução Nacional* (PRN). Franco was the vice-president of President Collor de Mello, who had created the PRN and left power after an impeachment (www.biblioteca.presidencia.gov.br).

the government coalition, increasing her chances of being impeached.¹⁶⁴ This type of argument is behind the definition of the Brazilian presidential system as ‘coalitional presidentialism’ (Cardoso and Graeff 2012, 32).¹⁶⁵

Apart from favoring the emergence of multiple political parties, electoral systems ruled by proportional representation may vary in the type of lists used for elections.

Closed lists of candidates are used in Argentina. This means that voters vote for a party and parties control the creation of their lists of candidates for the legislature. Party leaders control not only the nomination, but also the order of each candidate on the list. Parties receive seats in the legislature according to the proportion of votes obtained. The candidates elected are taken from the lists in the order of their position thereon, until all the seats obtained by the party are filled. Once candidates are elected, leaders also control their careers and assign them resources and opportunities in the political enterprise (Jones 2002, 180; Cardoso and Graeff 2012, 29).

For these reasons, a successful political career requires excellent links with the party. Amongst other things, legislators should follow the voting instructions of the leaders.¹⁶⁶ The voting position of the governing party is controlled by the president. Additionally, governors are provincial party leaders who also influence the voting position through their provincial delegations in Congress (Jones 2002, 157). They control party list formation in provincial and national elections as well as provincial funds that mostly come from a common pool of fiscal resources collected by the national government. Accordingly, governor control over their legislators forms the backbone of a symbiotic

¹⁶⁴ Indeed, the PMDB has been part of all government coalitions since the return of democracy, except during the presidency of Collor de Mello (Marcelo Gonzatto, “Desde a redemocratização, PMDB sempre esteve no poder. Sigla ocupa cargos no primeiro escalão desde a gestão Sarney, em 1985,” ZH Notícias, March 28, 2016, accessed March 30, 2016, <http://zh.clicrbs.com.br/rs/noticias/noticia/2016/03/desde-a-redemocratizacao-pmdb-sempre-esteve-no-poder-5531762.html>).

¹⁶⁵ On ‘coalitional presidentialism’, see Abranches (1998) and D’Araújo (2014).

¹⁶⁶ Legislators that dissent with their party usually abstain from voting or leave the assembly (Jones 2002, 157).

relationship between national and provincial politics through nomination, voting instructions, and the gravity of the national government in provincial finances (Eaton 2002, 299; Stein and Tommasi 2008, 82; 96). Through these mechanisms, party leaders, especially from the dominant party, are assured of legislators' obedience in congress and of their support to the president, as shown in Table 3.2.¹⁶⁷

Open lists of candidates are used for elections in Brazil. This means that a candidate's position on a list is not determined by party leaders, but depends on the number of votes received individually (Cardoso and Graeff 2012, 34). Voters can vote either for the party or for individuals, but they mostly vote for individuals (Mainwaring 1999 cited in Ames 2002). The votes won by all the candidates of each party add up to those won by the party label. Each party gets a number of seats in the legislature proportional to the number of votes obtained jointly by its candidates and its label. If a party gets ten seats, its ten top vote winners are elected (Ames 2002, 68; Desposato 2006, 57). In Brazil, candidates receive weaker electoral support from their party than their counterparts in Argentina. Hence, parties have less control over legislators' vote when they reach Congress (Cardoso and Graeff 2012, 30).¹⁶⁸

Moreover, economic power embedded in the public and private sectors is increasingly represented by key political players, as election campaigns are increasingly expensive. Legislative candidates are in search of constituencies to represent (Cardoso and Graeff 2012, 31). Their electoral chances can be bolstered by the support of influential

¹⁶⁷ Provincial interests can trigger party indiscipline in Congress, especially if fiscal policy is concerned.

¹⁶⁸ Brazilian political parties vary enormously in terms of organizational strength and jurisdictional presence. Most of them exist at the local or state level, but not at the national level (Ames 2002, 72; 75-6). Due to the procedure used for seat allocation, smaller parties have fewer chances to get seats. However, a candidate whose individual total is not enough for a seat may obtain sufficient votes as part of an alliance with other parties. Therefore, small parties align with larger ones to get a larger joint total of votes. These are electoral alliances and do not imply joint voting in Congress. If electoral alliances are inconsistent across states, delegations from the same party from different states are less likely to share a common program at the national level (Cardoso and Graeff 2012, 30).

interest groups and their re-election chances¹⁶⁹ depend more and more on how well legislators cater to these clienteles.

For the reasons mentioned above, Brazilian political parties are weak in the electoral arena (Stein and Tommasi 2006, 124). However, they are strong in the legislature and their collective decisions determine how Brazil is ruled and by whom.

In effect, the electoral system usually creates insufficient legislative support of the president (Cardoso and Graeff 2012, 32), encouraging the latter to build legislative alliances including most political parties.¹⁷⁰ In order to maintain a stable legislative majority¹⁷¹, the president appoints representatives of allied parties to seats in the cabinet (Cardoso and Graeff 2012, 30). The role of linking the executive to legislative support belongs to party leaders. They present the executive with the requests of their party members while indicating their voting position on a bill to get legislative support for the measures of the former (Cardoso and Graeff 2012, 30). The most successful legislators will vote according to the direction of the leaders of the governing coalition. These ones also control resources independently from the executive that can be delivered to committed legislators (Alston et al 2008, 127-8). Through these mechanisms, high discipline towards the governing coalition is assured in Brazilian Congress, as shown in Table 3.2.¹⁷²

It is worth acknowledging here that in addition to the effect of electoral and party systems in the degree of separation of powers in presidential systems, the legislative faculties of the executive also influence the functioning of the legislatures. As recorded in Table 3.2, presidents in both South American countries are constitutionally entitled to

¹⁶⁹ Re-election rates are 90% in the U.S., 50% in Brazil, and 17% in Argentina (Morgenstern 2002; Cardoso and Graeff 2012).

¹⁷⁰ Members of different parties both in the left and the right wing participate in these negotiations, including the leaders of the government coalition appointed by the president (Cardoso and Graeff 2012, 32).

¹⁷¹ Since re-democratization, most elected presidents have built relatively stable post-electoral majority coalitions within Congress (Alston et al 2008, 122).

¹⁷² On the relative weakness of parties and the strength of Congress, see Cardoso and Graeff, 2012.

initiate legislation without intermediaries, use partial vetoes, legislate through executive authority decrees, and nominate legislators to the cabinet. This means that they have more tools to penetrate the legislative process than U.S. presidents. The legislative prerogatives of the president in Argentina and Brazil are discussed in Appendix 3.2.

To wrap up, the degree of separation between the legislative and the executive branches of power is lower in the presidential systems of Argentina and Brazil than in the U.S. presidential system. In Argentina, high party discipline in Congress brings the legislative and executive branches into a closer relation. Influence flows from the top down. The rank and file grant almost automatic support to leadership, within a range of acceptability. In Brazil, the legislative government coalition negotiates discipline in Congress and support to the president based on the dispersion of patronage among parties. Influence flows from the bottom up. Leader actions depend on party member support on a case-by-case basis. This relation between the legislative and executive branches lasts as long as the government coalition. In both countries, the proximity between the two branches of power is reinforced by the extensive legislative powers of the president that go beyond those found in other presidential and in parliamentary systems.

Moreover, the relation between the legislative and executive branches of power in the presidential systems of Argentina and Brazil is somewhat hierarchical. Although this type of relation is more typical between the intertwined powers of parliamentary systems, it may arise in presidential systems under two circumstances. The first one occurs when the president is at the head of a party with a legislative majority, as is generally the case under the one dominant-party system of Argentina (Soberg and Shugart 2006, 344-365). The second takes place if the president is at the head of a coalition that controls the legislative agenda, which is often the case in Brazil. In this case, “the transactions of a multiparty presidential system may generate an informal fusion of powers that binds the formally

separate executive and legislative branches together for the duration of the coalition” (Soberg and Shugart 2006, 344-365).

As shown, the nature of the electoral and party systems affects how presidential systems function. Some scholars (Mainwaring 1993; Haggard and McCubbins 2001) have further argued that a multiple party system combined with a presidential system generate less stable democracies¹⁷³. On the one hand, multiple parties exacerbate two problems found in presidential systems. First, there is a greater likelihood of executive/legislative deadlock, which stems from the separate election of the two branches of government. Presidents need coalitions composed of multiple parties to get measures through Congress. Yet, these coalitions are hard to build and to maintain (Mainwaring 1993, 200, 209, 214). Second, presidential systems are not flexible during crisis. Attempts to depose the president shake the whole system. Multiple parties aggravate this. When the president’s program does not have enough support in congress, there is no way of dismissing the president due to the fixed electoral timetable¹⁷⁴ (Mainwaring 1993, 208, 217-8). On the other hand, coalitions in presidential systems usually take place before elections and are not binding thereafter. Accordingly, governing coalitions may differ substantially from electoral coalitions. Incentives for parties to break coalitions are strong in presidential systems (Mainwaring 1993, 220-2).

The next section turns to forms of control over the bureaucracy in South America. The following pages uncover the extent to which the legislative controls to oversee the bureau used in the United States are also practiced in Argentina and Brazil.

¹⁷³ Some scholars (Linz and Valenzuela 1994) have argued that “presidential systems have inherent weaknesses that make them less favorable to sustaining democracy than parliamentary systems.

¹⁷⁴ Except for impeachment.

5. Legislative Control over the Bureaucracy in Argentina

This paper addresses the issue of how delegation of political authority and control over the bureaucracy is affected by the way in which electoral and party systems condition the degree of separation between legislative and executive powers in presidential systems. Legislative control over the bureaucracy in the United States reflects a presidential system in which legislative and executive branches of power are separate. Due to incentives created by the electoral and party systems, these two powers are closer in the presidential systems of Argentina and Brazil.

The current section will show how despite the similarities with the formal institutions of the United States, legislative control over the bureaucracy in Argentina does not follow the U.S. system of control. Neither legislation nor budgets are legislative control tools in Argentina. Instead, control over the bureaucracy reflects a presidential system in which the legislative and executive branches of power are closer and more concentrated under the president. This is due to elections ruled by proportional representation and closed lists and a multiparty system in which one party is dominant.

The most important forms of control in the hands of the legislatures of Argentina and Brazil (these ones will be analyzed in the next section) have been recorded in Table 3.3. They have been classified according to the timing of control, the unit in charge of control, and the extent to which they are prevalent tools to oversee the bureaucracy. In order to facilitate the comparative analysis, the controls practiced in the United States and in parliamentary systems have been also included.

Table 3.3: Legislative Controls: United States, Brazil, Argentina, and Parliamentary Systems

Type of Control	Unit in charge of Control	U.S.	Brazil	Argentina	Parliamentary
<i>Ex ante / On going</i>					
Legislation	Committees/Chambers	Main	YES	NO	NO
Budget Process	Committees/Chambers	Main	YES	NO	NO
Confirmation of Executive Appointments	Senate	Secondary	YES	YES	NO
<i>Ex post</i>					
<i>Investigative</i>					
Budget Auditing	Supreme Audit Institution	Secondary	YES	YES	Main
Hearings	Committees/Chambers	NO	YES	YES	Main
Interrogations	Committees/Chambers	NO	YES	YES	Secondary
Interpellations	Committees/Chambers	NO	YES	YES	Secondary
Inquiries	Committees/Chambers	Secondary	YES	YES	NO
External Investigations	Ombudsman	NO	NO	YES	Secondary
<i>Sanctions against the Executive</i>					
Motion of censure	Chambers	NO	NO	YES	Secondary
Impeachment	Chambers	Exceptional	YES	YES	NO

Source : Author

As already mentioned, the U.S. constitution was the model for the Argentine one. The constitution of Argentina contains provisions to permit Congress to use legislative control methods similar to those used in the United States. It grants the provisions on legislation (art. 76-77; 84; 99; 100); budget control (art. 85; 100); confirmation of executive appointments (art. 99); hearings, interrogations (art. 100), interpellations, and enquiries (art. 71); as well as impeachment (art. 53; 59-60). The last constitutional reform of 1994, intending to attenuate the presidential system¹⁷⁵, granted Congress two additional tools: the motion of censure (art. 101) and the ombudsman office (art. 86).

Legislators in Argentina seldom draft legislation in detail. Their career incentives depend on a strong party discipline. Thus, legislators do not have political incentives to bind the president's leeway with detailed legislation. In addition to that, Argentine legislators are not very professionalized and do not possess many technical and organizational resources. As a result, they use approximate language, design simple administrative procedures, and leave detailed determination of procedures to the bureaucracy (Eaton 2003, 55-56) or the executive. This is more similar to what happens in parliamentary systems.

¹⁷⁵ As mentioned in the law 24309.

However, politicians do control bureaucrats by means of administrative procedures (Eaton 2003, 36). As the executive proposes most of Argentine legislation¹⁷⁶ (Cox and Morgenstern 2001, 460), the president can introduce bill proposals in broad legislative language. Details on the administrative procedures can be added later in the drafting of presidential decrees or cabinet resolutions to control and reduce bureaucratic discretion. So Argentine legislation is not an expression of control in the hands of the legislature, but it may become a tool for control by merger of legislative and executive powers concentrated in the hands of the president.

One particular use of the legislation as control tool, common in parliamentary systems (Huber and Shipan 2002, 29) and often practiced in Argentina, is the reorganization of government departments and jurisdictions by means of legislative bills. In many situations, these bills proposed by the president were approved in Argentina because the executive dominated both houses in Congress through legislative majorities. In other situations, the legislature was more politically willing and capable of incorporating amendments (Eaton 2003, 46). So, the role of the legislature in the use of this tool is conditioned by both the legislative powers of the president and the political circumstances determining his/her capacity to penetrate legislative affairs.

As mentioned previously, U.S. legislators are interested in overseeing the bureaucracy independently from the actions of the executive. For them, information on bureaucratic activity from interest groups represents an important resource for legislative control over bureaucrats, including legislators belonging to the governing party. In contrast, participation of interest groups in legislative oversight of the bureaucracy is less important in Argentina. Instead of influencing policies through Congress, interest groups in Latin America have privileged access to the executive and party leaders, which can be seen

¹⁷⁶ Argentine Congress mostly approves, refuses or amends the bills introduced (Cox and Morgenstern 2001).

as part of the heritage of corporatism in the region¹⁷⁷ (Eaton 2003, 34-35). When interest groups are not satisfied with a certain aspect of bureaucratic behavior, they supply information directly to party leaders. The latter generally promote the collective interests of the party. These are often incompatible with the specific and organized interests of interest groups. Consequently, leaders generally ignore the demands of interest groups. In the long term, the latter limit the information they give out to the legislative branch on the bureaucracy (Eaton 2003, 40). In other words, interest groups seldom try to influence the legislature in order to participate in the design of administrative procedures and control of the bureau. They favor the executive when they wish to influence policy making (Eaton 2003, 34). Accordingly, the information interest groups provide is channeled in a more centralized and concentrated manner than in the United States. The channels of their influence are to be found in detailed administrative procedures inside executive decrees and cabinet resolutions as opposed to inside the laws *per se*.¹⁷⁸

In the U.S. presidential system, the executive generally prefers to shape the higher bureaucracy by nominating officials and leave their confirmation to the Senate (Spiller and Urbiztondo 1994), even if interest groups may influence legislators in this regard. Congress prefers a higher bureaucracy formed by career civil servants, so as to contain their discretion by means of detailed procedures inside legislation.

In contrast, the Argentine constitution requires the confirmation of the Senate for a limited number of officials, leaving the rest to the discretion of the president¹⁷⁹ (Lemos and

¹⁷⁷ Corporatism usually refers to the policy-making practices of some countries, which feature tripartite negotiation among business associations, labor unions, and government. For a further discussion, see the seminal article of Schmitter (1974).

¹⁷⁸ The way in which interest groups exert influence on politicians is well beyond this work. For some discussions related to the topic, see Spiller (1990); Dal Bo et al (2006); and Bebchuk and Neeman (2010).

¹⁷⁹ According to constitutional provisions, Senate confirmation is required for appointing judges of the Supreme Court as well as federal judges. It is also necessary to appoint, dismiss, and promote ambassadors, ministers, and *chargés d'affaires*; and to appoint and promote higher officials of the three armed forces (Constitution of Argentina, art. 99). In addition to the constitution, other laws order Senate confirmation for

Llanos 2006, 11). Furthermore, the Senate has no constitutional prerogatives to participate in confirmation or dismissal of appointments in the cabinet (Eaton 2003, 47). Rather, the president has the exclusive power to nominate and discharge the chief of cabinet, ministers, officers of the presidential secretariat, consular agents, as well as other officers whose appointment is not otherwise regulated (Constitution of Argentina, art. 99.7). Thus, the nomination of government officials and the organization and reorganization of the bureaucracy respond more easily to executive interests in the presidential system of Argentina than in the United States. This situation also allows interest groups to address executive authorities directly when they search to exert their influence.

Regarding the budget, the chief of cabinet has the right to send the executive proposal to Congress (Constitution of Argentina, art. 100) and Congress has the right to legislate and establish expenses and revenues according to the plans of the executive (Constitution of Argentina art. 75). Despite these formal powers, the budget process is not a main form of legislative control in Argentina, as shown in Table 3.3. In fact, in economies prone to inflation like Argentina, the budget is rarely approved on time and is always subject to executive revision after Congressional approval¹⁸⁰ (Eaton 2003, 40).

External audit institutions with budget responsibilities are one of the most common forms of control over the bureaucracy in presidential and parliamentary systems particularly (Huber et Shipan 2002, 29). The constitutional reform of 1994 in Argentina recognized the importance of this type of institution. It granted constitutional status to the *Auditoria General de la Nación* (AGN), external audit institution of public accounts under the authority of the legislative power (Constitution of Argentina, art. 85), which is

other positions. This is currently the case for the president, vice-president, and directors of the central bank (Law 24144, art. 7) as well as the general attorney, general defender, and all other magistrates of the public ministry (Law 24949, art. 4).

¹⁸⁰ As of 1991, greater macro-economic stability made budgets more viable controls. However, the crisis between 1999 and 2002 once again denied their pertinence (Eaton 2003, 40).

discussed in more detail in Appendix 3.3. Its creation represents an improvement in terms of control in the sphere of Congress. Yet, its effectiveness is still limited. Although the agency falls under legislative jurisdiction, the executive can reduce its budget (Morgenstern and Manzetti 2000, 40). Moreover, the constitution mandated the external control of the budget to be in the hands of the opposition party, but current legislation has allowed the AGN to make decisions according to a simple majority of votes by its seven members. This means that if the president wins a majority in Congress, he/she can interrupt initiatives of the AGN with the votes of the members chosen by the legislators of the governing party (Despouy 2015, 1-2).

Other legislative methods of control allow for controlling highly ranked officers. According to the constitution, either of the houses of Congress can call on the ministers to present explanations to the assembly (Constitution of Argentina, art. 71). All ministers must produce written or verbal reports and explanations that are required by the legislature (Constitution of Argentina, art. 100.11).

One of the changes introduced by the constitutional reform of 1994 with the intention of attenuating the presidential system of Argentina was the incorporation of the chief of cabinet. This key minister can be called upon by Congress in view of a motion of censure, which is a control tool more common in parliamentary systems, as shown in Table 3.3. The motion can lead to his/her removal from office if the absolute majority in the house agree (Constitution of Argentina, art. 101).

Despite the changes introduced in the constitutional reform, the Argentine Congress has retained its constitutional power to impeach the president, vice-president, chief of the cabinet, ministers, and judges of the Supreme Court (Constitution of Argentina, art. 53 and 59), like the U.S. legislature. However, neither motion of censure nor impeachment have been used in Argentina since the return of democratic rule in 1983.

Although the constitution does not grant explicit investigative powers into Congress, enquiries are a necessary step previous to the application of other controls, such as motion of censure and impeachment. Thus, the investigative powers of Congress are implicit within the constitution and explicit within the rules of the House of Representatives (art. 104) and Senate (art. 87). The legislature can form commissions of enquiry with members of the same house or of both houses. Congress can define the scope of investigative powers these commissions have, as well as the length of their duration. Despite this, some scholars (Spiller et Tommasi 2008, 97) argue that most legislators consider enquiries inefficient in terms of controlling the bureau.

Another external control measure is the *Defensor del Pueblo* (Ombudsman), an independent entity in the sphere of legislative power (Constitution of Argentina, art. 86).¹⁸¹ Due to the fact that its resolutions are not binding, its power resides in mediation, conciliation, and recommendations (Ugla 2004, 432; Pelizzo and Stapenhurst 2012, 31-32).

A summary of the arguments above has been recorded in Table 3.4, which includes the main attributes of delegation and control in Argentina, Brazil, and the United States as well as some key components of these three presidential systems.

¹⁸¹ The agency was created by law 24284/93 (amended by law 24379/94). The person appointed to the ombudsman office by Congress has a five-year mandate and can be removed from office by the legislature. Its activities are reported annually to Congress (Defensor del Pueblo 2015).

Table 3.4: Legislative Delegation and Control in the United States, Brazil, and Argentina

AUTHORITY DELEGATION & CONTROL	US	BRAZIL	ARGENTINA	PARLIAMENTARY
Delegation				
Degree of Bureaucratic Discretion	low	HIGH	HIGH	high
Control				
Timing	Ex ante	ON GOING - EX POST	EX POST	Ex post
Law	Main	YES	NO	NO
Budget	Main	YES	NO	NO
Budget Auditing	Secondary	YES	YES	Main
Hearings	Secondary	YES	YES	Main
PRESIDENTIAL SYSTEMS	US	BRAZIL	ARGENTINA	
Electoral System	Plurality-Majority	Open Lists PR	Closed List PR	
Party System	Two Parties	Multiparty (coalitions)	Multiparty (one dominant party)	
Penetration of Executive in Legislative Affairs	low	HIGH	HIGH	
Degree of Separation of Powers	high	LOW	LOW	
Type of Presidential System	Separation of Powers	Coalitional	One Dominant Party	
BUREAUCRATIC CONTROL	Legislative Control over Bureaucracy Autonomous from Executive Control	Coalition Control over President Legislative Control over Bureaucracy	Political Control over Bureaucracy Centralized by the President	

Note: PR means proportional representation.

Source: Author

The Argentine Congress delegates authority with substantial discretion, due to the lack of detailed administrative procedures within the laws. Despite being modeled on U.S. institutions, none of the foundational elements in the United States system are important mechanisms in Argentina. Legislators in Argentina have neither the resources nor the incentives to include *ex ante* control through detailed administrative procedures inside the legislation. The budget process has never shown potential as a control tool because of limited periods of economic stability. So, the allocation of ‘ongoing’ and *ex post* rewards and punishments to agencies and departments are beyond legislator capacity.

Further, interest groups that are key actors in U.S. legislative control do not benefit from providing information about bureaucratic activity to Congress in Argentina. They seek rather to exert their influence through direct dialogue with party leaders and executive authorities. The design of administrative procedures is under this sphere. As a result, legislative control over the bureaucracy in Argentina does not follow the U.S. model.

Executive appointments seldom require senatorial approval and investigative tools have considerable flaws. Impeachment is available but has not been used since the return of democracy. In an attempt to temper the presidential system, parliamentary features of control have been introduced such as motion of censure and the ombudsman office, or enhanced such as external budget controls. Indeed, improvements in legislative oversight of the bureau over the last years are related to the upgraded role of the supreme audit institution. Yet, one of the most important contributions the legislature has made in terms

of overseeing the bureau has been that of legislative approval of administrative reorganization bills initiated by the president.

Hence, legislative oversight over the bureaucracy in Argentina relies usually on elements of control typically found in parliamentary systems, but performed by the merger of legislative and the executive branches of power. Legislative authority over the bureaucracy is delegated not only by Congress, but also by the executive that has its own legislative powers including pre-eminence in legislative initiative. Accordingly, control of legislative delegation over the bureau is usually performed by both branches concentrated under the power of the president. In this sense, control over the bureaucracy is more political than legislative, as summarized in Table 3.4.

This is consistent with a multiparty presidential system in which legislative and executive branches of power are closer than in the United States and concentrated under the power of the president, who belongs to the dominant party. In short, the president, who dominates the two branches (the dominant principal), controls the delegation of legislative authority over the bureaucracy (the agency).

As previously discussed, this relationship between branches of power is attained through elections ruled by proportional representation and closed lists and a multiparty system in which one party is dominant, as recorded in Table 3.4. When the president belongs to the party that dominates the political system, which has actually happened over the last two decades, party leaders of the dominant party assure legislators' discipline not only in Congress, but also legislative support to the president. In these circumstances, legislative control over the bureaucracy constitutes control in the hands of

the president and legislative control implying accountability and sanctions against the executive is unlikely practiced.¹⁸²

The next section turns to legislative control of the bureau in Brazil.

¹⁸² If the president does not belong to the party that dominates the political system, which has been the situation since December 2015, controls over the bureaucracy performed by the legislature would work as controls in the hands of the dominant and opposition party. The new administration offers an opportunity to study further this topic.

6. Legislative Control over the Bureaucracy in Brazil

This section asks whether the bureaucratic control methods used in the United States are practiced in the presidential system of Brazil. It will show that Brazil follows the U.S. system only partially. Legislative amendments of laws and budget allocations are widely used. Yet, these elements of control coexist with parliamentary features. This reflects to a presidential system in which the government coalition brings the legislative and executive branches of power closer to each other temporarily. This is due to elections ruled by proportional representation and open lists and to multiple political parties.

Also originally modeled on the United States, the Brazilian constitution went through different reforms throughout the twentieth century. After democratization, the new constitution was enacted in 1988 and enhanced the scope of Congressional oversight over the bureaucracy that was constrained by the military government¹⁸³ (Cheibub Figueredo 2003, 183). As shown in Table 3.3, Congress relies on an array of control mechanisms that include legislation (Constitution of Brazil, art. 61; 64); the confirmation of executive appointments (Constitution of Brazil, art. 52); budget controls (Brazilian Constitution, art. 71-73); hearings and interrogations (Constitution of Brazil, art. 50), interpellations and enquiries (Constitution of Brazil, art. 58); and impeachment (Constitution of Brazil, art. 51-52).

As in Argentina, Brazilian legislators do not have access to enough resources to draft the details of comprehensive packages of legislation. This does not mean that Brazil does not make use of legislation as an oversight tool. Instead, Congress applies a ‘vernacular version’ of this form of control. Brazilian legislators endow the president

¹⁸³ The current Brazilian Federal Constitution of 1988 was amended every year since 1992, but 1994.

with important legislative powers, such as legislative initiative and executive authority decrees. This allows Congress to benefit from the superior technical support of the executive and bureaucracy in the drafting of legislation. In order to retain control over legislative acts, the Brazilian Congress prefers individual supervision by means of amendments¹⁸⁴ (Reich 2002, 25). Legislators use open amendments that allow them to modify the legislative acts of the president. This control tool is regulated by the internal rules of each house (*Regimento Interno Camara dos Deputados*, art. 118; *Regimento Interno Senado Federal*, chap. IX). If ‘whatever is formalized in the United States tends to persist’, it is possible to state that ‘whatever is formalized in Brazil can be amended’. In contrast to the United States where multiple veto players succeed in protecting the *status quo*, Brazilian legislators try to avoid gridlocks produced by multiple powerful actors with this tool (Reich 2002, 17).

As in the United States and Argentina, the Brazilian constitution requires Senate confirmation for executive appointments of highly ranked officials. The differences across countries¹⁸⁵ reside in the type and number of appointments requiring confirmation.¹⁸⁶ Except for chief officials whose nomination is confirmed by the Senate,

¹⁸⁴ Some legislatures have both the legal authority and the technical capacity to amend or reject a budget proposal and substitute it with a budget of its own. Others are able to amend or reject the proposal presented by the executive but not to formulate a budget. Still others lack the capacity to amend the budget proposed, so they approve whatever budget the executive presents without any changes (Stapenhurst et al 2008; 142).

¹⁸⁵ Regarding the Brazilian Foreign Service, the appointment of ambassadors, and other chiefs of permanent diplomatic missions, require the consent of the Senate (Constitution of Brazil, art. 52), as in Argentina. Regarding the judiciary, it is the prerogative of the Brazilian Senate to confirm nominations for the federal supreme court, military superior court, labor superior court, justice superior court as well as the general attorney (Constitution of Brazil, art. 52). However, appointments of Brazilian federal judges and Brazilian armed forces need no confirmation, in contrast with Argentina (Barreiro Lemos and Llanos 2006, 13).

¹⁸⁶ Other nominations requiring the approval of the Senate include one-third of the ministers of the *Tribunal de Contas da União*, the president and directors of the Central Bank of Brazil (Constitution of Brazil, art. 52), the presidents, directors, and counsellors of regulatory agencies, and main officials of the Brazilian

the Foreign Service and the judiciary in Brazil retain these *interna corporis* decisions and control appointments and dismissals of their officials (Barreiro Lemos and Llanos 2006, 13). The preference for officials with meritocratic careers in the public bureaucracy is a trait more frequently found in parliamentary systems (Grindle 2010, 5). Regarding the cabinet, in contrast to the United States, the Brazilian Senate has no constitutional prerogatives to confirm its members (Constitution of Brazil, art. 84). Like in Argentina, these prerogatives are exclusive to the president. Notwithstanding, cabinet nominations in Brazil are used for coalition building in Congress. As previously discussed, they are subject to demands from parties belonging to the government coalition. Even if confirmation rates are high in Brazil and can attain over 90 percent, they highlight the negotiations behind confirmations (Barreiro Lemos and Llanos 2006, 12-14).

The budget process presents another opportunity for control through amendments. The president has the right to initiate budgetary bills (Constitution of Brazil, art. 165), while appropriations do not need congressional approval, in contrast to the United States. So the budget process in Congress focuses on debating, amending and approving two components of the budget: its guidance law and the budget itself. Once budget items get congressional approval, regulations for budget execution allow the Brazilian government plenty of leeway to reallocate them. At the same time, the constitution grants Congress rights to modify budget bills (Constitution of Brazil, art. 166). In effect, the legislature can pass legislation that modifies the approved budget and authorizes transfers of resources from one item to another. It may also alter revenue figures provided it proves that the executive has made ‘errors or omissions’. This results in many budget

intelligence agency (Barreiro Lemos and Llanos 2006, 13).

amendments each year (Cheibub Figueredo 2003, 186). In this context, the control of the budget process becomes critical. Detailed scrutiny of the budget proposal takes place in the *Comissão Mista de Orçamento* (Constitution of Brazil, art. 166), the joint permanent budget committee composed of senators and deputies (Blondal et al 2003, 115).¹⁸⁷

As shown in Table 3.3, the Brazilian constitution also grants Congress the right to practice *ex post* controls over government accounts. This is performed through a supreme audit institution: The *Tribunal de Contas da União* (Constitution of Brazil, art. 71), which is discussed further in Appendix 3.3. The external control of public accounts has improved over the decades. However, tribunal reports tend to be favorable with some specific criticism. They are usually presented on time, but are unanimously approved by the legislature long after their publication, even beyond the respective president's term. Further, tribunal ministers seldom follow the recommendations about policy changes and sanctions prepared by technical staff (Cheibub Figueredo 2003, 186).

It is worth noting that interest groups and individual citizens have constitutional rights to participate in external budget control. They have access to data from the Congress information system¹⁸⁸ (Cheibub Figueredo 2003, 185) and can denounce undue actions to the tribunal (Constitution of Brazil, art. 74).

¹⁸⁷ Formerly oriented to deliver 'pork' to senior members, the budget procedure of the joint committee changed, aiming to redistribute benefits to the majority of legislators (Ames 2002, 228-30). It limited congressional amendments to budget by restrictions on their number and amount. Amendments were limited to 20 individual amendments for legislator and less than \$750,000 per amendment; five amendments for sectoral committee and no monetary limit; 20 amendments for group of legislators from the same state and no monetary limit (Blondal et al 2003, 117; Cheibub Figueredo 2003, 186).

¹⁸⁸ The *Secretaria Especial de Informática do Senado Federal* (PRODASEN) is the Congress information system. Since the return of democracy, PRODASEN has grown and improved its structure and staff. Employees are more responsive to committees than to individual legislators (Cheibub Figueredo 2003, 184).

Brazilian legislators rely on a variety of investigative control methods. According to the constitution, any Congressional committee or house of Congress is entitled to ask cabinet members to present themselves before the legislature and provide explanations, reports, and answers to the questions that they are asked (Constitution of Brazil, art. 50, 58). Since the new constitution of 1988, individual legislators can make any of these requests, provided they receive approval from the respective committees (Cheibub Figueredo 2003, 187).¹⁸⁹ Like in the United States and Argentina, the Brazilian legislature can form commissions of inquiry with members from the same house or from both houses (Brazilian Constitution, art. 58). In Brazil, the *Comissões Parlamentares de Inquérito* are temporary committees formed to investigate allegations of wrongdoing, administrative failures, or corruption, amongst others. Investigative powers of these commissions are equivalent to those of judicial authorities and their reports can constitute the basis for further investigation by the judiciary and eventual sanctions. Nevertheless, the work of these commissions is often ineffective. In certain cases, their members were never appointed. Appointments are the responsibility of party leaders. By simply not completing this action, leaders in the government coalition can prevent investigations. (Cheibub Figueredo 2003, 175-6).¹⁹⁰

As mentioned previously, the conclusions of these investigations may be the first step towards changes in public policies or imposition of sanctions such as impeachment. With procedures analogous to those found in the United States and Argentina, the

¹⁸⁹ Members of cabinet have often been interrogated about state agencies management (54%), social policies (30%), and infrastructure programs (16%) (Cheibub Figueredo 2003, 189).

¹⁹⁰ Unlike Argentina, Brazil does not have an Ombudsman that belongs to the legislative sphere. Instead, the country relies on an institution called *Ministério Público*, which belongs to the justice system (Mainwaring and Welna 2003, 203; Power and Taylor 2011, 19).

Brazilian Congress has the constitutional faculty to use this tool to exert control over the president, vice-president, and ministers (Constitution of Brazil, art. 51-52), as shown in Table 3.3. Indeed, the conclusion of the commission of inquiry that investigated corruption during the administration of President Collor, between 1990 and 1992, supported initiation of impeachment against the president (Cheibub Figueredo 2003,177).¹⁹¹ President Rousseff has been facing impeachment threats since March 2015. First, an opponent legislator called for her impeachment alleging illegal financing of electoral campaigns. Later, a legislator from the PMDB party, the most important ally of her government, asked for a commission of enquiry on a corruption scandal at the Brazilian state oil company Petrobras (*Camara dos deputados* 2015). Then, the PMDB abandoned the government coalition. In April 2016, the initiation of the process was approved by the house of representatives (*Camara dos deputados* 2016). Thus, although impeachment is a tool reserved for exceptional circumstances, the Brazilian Congress has used it or threatened to do so more frequently than in Argentina or the United States.

To wrap up, Congress in Brazil delegates authority granting considerable degrees of bureaucratic discretion, due to scarce resources for drafting complete detailed procedures in the laws. Law and budgets are significant tools for control, like in the United States, as summarized in Table 3.4. In effect, Congress resorts extensively to legislative amendments that are ‘ongoing’ control tools by definition. Amendments of administrative procedures and budget allocations allow Congress to concentrate control on focal points addressing veto players and gatekeepers. Indeed, amendments are an

¹⁹¹ The Senate found President Collor guilty, removed him from office, and disqualified him from holding office for eight years. His former vice-president Itamar Franco became the president in December 1992 (Cheibub Figueredo 2003,177).

instrument for the government coalition to control (and negotiate with) the president rather than legislative tools to oversee the bureau. Moreover, Congress controls government accounts externally by means of audits of the resourceful *Tribunal de Contas da União*, which has gone through sustained improvement. Therefore, Brazil combines its use of budget amendments that is closer to methods used in the United States, with a congressional budget committee and a supreme audit institution. Such channels are preferred in parliamentary systems.

Powerful interest groups and other societal actors in Brazil have two channels to participate in legislative control of the bureaucracy. The first one is through legislators by means of electoral incentives, like in the United States. The second is through the tribunal by means of constitutional rights.

In terms of confirmation of appointments, the Senate has the constitutional duty to confirm the executive nomination of certain high ranked officials, as in the United States. Yet senatorial confirmations are not necessary in two important cases. The first case regards the cabinet, where ministers do not need the consent of the Senate but the consent of the government coalition in Congress. The second concerns meritocratic bureaucracy, where Congress relies on career civil servants to whom it grants discretion and *ex post control*, following the model preferred in parliamentary systems.

The use of investigative tools in Brazil is conditioned by the cohesiveness of the government coalition in Congress, which can either prevent or promote the creation of commissions of enquiry against the executive. Directly related to this is the frequent use, or threat of, impeachment observed in Brazil. This is a distinctive Brazilian feature.

Hence, Brazil follows the U.S. model of control partially. Elements widely used in the United States coexist with common parliamentary features, as summarized in Table 3.4. On the one hand, some typical presidential control tools (amendments, budget, executive appointments) are widely used by the government coalition to oversee and negotiate with the president. Others (inquiries, impeachment) are used to oversee the president in order to put an end to the government. On the other hand, Congress controls the bureaucracy wherein many high ranked officials are career civil servants, and uses *ex post* methods such as external budget auditing common in parliamentary systems, as in the United Kingdom and Canada. This duality of controls is consistent with a presidential system in which a multiparty coalition in Congress constitutes the ground upon which the executive stands.

In effect, oversight of the bureaucracy is performed by the government coalition in Congress. Legislative authority over the bureaucracy is delegated by Congress. The president has considerable legislative powers. Yet, the government coalition in Congress also penetrates the executive by means of their representatives in the cabinet. In short, the government coalition in Congress (the principal) uses legislative delegation and control to oversee the bureau (the agent) as well as manage support and negotiation with the president. As long as the government coalition in Congress remains unchallenged, it assures a high level of discipline amongst the majority of legislators to the coalition and legislative support to the president. As previously discussed, this relationship between branches of power is attained through elections ruled by proportional representation and closed lists and a multiparty system, as recorded in Table 3.4.

The next section provides an illustration of the main argument of this paper.

7. The Case of the Civil Service System in Brazil and Argentina

This section provides an illustration of the argument developed in the previous sections with the study of how civil servants are appointed in Brazil and Argentina.

First, it presents the two main ways in which civil services recruit their staff in modern democracies. Then, it will demonstrate that the selection and promotion of civil servants in Brazil express control methods over the bureaucracy that combine presidential and parliamentary features under the command of the governing coalition. Later, it will show that the civil service in Argentina involves oversight tools typically found in parliamentary systems in the hands of the president.

There are two main arrangements to nominate civil servants that coexist in modern democracies around the world: political appointments and career systems. Political appointment of officers, or patronage¹⁹², is an ancient form by which political leaders are granted the discretion to appoint collaborators who support their policy initiatives and show loyalty through their advice and leadership, independently of any systematic examination or credentialing system. These nominations can usually be controlled and contested by members of the executive, legislature, political parties, and unions, amongst others. Although political appointments are ubiquitous, they usually characterize the top-level positions in governments of all countries (Grindle 2010, 3).

The other arrangement is by nomination through the civil service system, wherein most non-elected officials are hired and promoted through a process based on merit that usually includes education credentials and examinations certified by the state. In this

¹⁹² These two expressions are often used as synonyms. However, political appointments may denote systems wherein appointees are professionalized and subject to ethical codes.

system, tenure in public employment is secure, barring malfeasance in office. Movements in and out are regulated and compensated, such as retirement. Non-partisanship criteria in the selection and promotion of officials assure that they perform duties for the state, not for the party or patron. Such a system relies on formal rules and procedures (Grindle 2010, 4-5). Today, most democracies have legislation establishing some type of career civil service (Grindle 2010, 1-2), although differences as to the extent and sustainability of the system as well as criteria of merit, tenure, and non-partisanship can be substantial across countries.

The U.S. civil service evolved from a nineteenth century patronage system¹⁹³ to the current one wherein political appointees at the upper levels coexist with tenured civil servants in the lower levels (Grindle 2010, 1). As noted in section 3, presidents and the executive generally prefer a bureaucracy composed of political appointees. High bureaucrats are usually appointed by the executive and confirmed by the Senate (Spiller and Urbiztondo 1994). Such political appointments can be controlled from above, restricting congressional control over the bureau (Spiller and Urbiztondo 1994). On the other hand, legislators prefer a career civil service, which they can at least partly influence by means of detailed legal procedures (Moe and Caldwell 1994, 174-6; Lemos and Llanos 2006, 11).¹⁹⁴

The civil service system in the U.S. serves the at times contradictory interests of

¹⁹³ In the nineteenth century, U.S. government jobs were allocated to relatives and supporters of members of the winning party as rewards and incentives to loyalty towards the party. In 1883, the Pendleton Civil Service Act created the Civil Service Commission and established a merit-based system at the Federal Government. Yet, the system was extensively adopted only in the 1930s (Grindle 2010, 1).

¹⁹⁴ Political appointees are widespread in all the scale of the U.S. bureaucracy. In an attempt to improve the quality of the public sector work, President Clinton's administration tried to implement initiatives such reduction of red tape, customers first, and employees' empowerment. Laws that were necessary to make these changes did not pass (Wilson 2000, ix-xiii).

the two principals expected to control the bureaucracy: the president and Congress. Then, the principal-agent problem is typically dealt with, also in somewhat contradictory fashion, by means of detailed administrative procedures favored by legislators that reduce *ex ante* the discretion of bureaucrats, and by the hiring of political appointees who are responsive to the executive.

In parliamentary systems, bureaucracies have relatively fewer political appointees at their upper levels than the United States (Spiller and Urbiztondo 1994). The process of hiring and promoting government employees is mainly ruled by a career system based on merit, tenure, and non-partisanship. The few political appointees are usually in a limited number of very senior management positions, and these appointees often serve at the discretion of the governing party. Such appointments are used to create a link between elected politicians and the bureaucracy as a whole.

In a parliamentary civil service system, the principal-agent problem is primarily a clash of interests between elected politicians and bureaucrats. It is dealt with by granting high degrees of discretion to career civil servants appointed on merit and controlled *ex post*, and by use of some (essentially) political appointments at the highest level of the bureau in a manner that links the cabinet with the bureaucracy as a whole (Moe and Caldwell 1994, 174-6).

In Latin America generally, patronage is widely present in the hiring of government employees. The reason for this widespread practice is to build electoral and party support. Jobs generate votes for the party, and are used to pay off political obligations after an election (Grindle 2010, 1-2).

Reform oriented presidents and ministers have tried at times to reduce patronage.

This has encouraged the responsiveness of bureaucrats to the leadership of the reformer. In some cases, special ‘islands’ within the bureaucracy generating ‘pockets of efficiency’ have been created (Evans 1989). In some extreme cases, a parallel public sector has been created with special hiring codes and salaries which are not subject to regular personnel rules (Grindle 2010, 22-23).

In Latin America, employees politically appointed at low/middle levels of the bureaucratic ladder usually gain tenure through unionization. Access to these positions is generally controlled by union bosses and allocated for partisan reasons. Unionization in these cases means permanency in a formal public sector job, including constraints on dismissal from service (Grindle 2010, 22-23).

Although political appointments remain widely in evidence, the public sector in the region has made advances in the degree of stability and professionalism in public office. One of the factors that explain this improvement is that some agencies or ministries have wrested control of recruitment from partisan influence and have even used political appointments to hire qualified staff (Grindle 2010, 1-2). Another factor is that the education level of upper and middle rank officials has improved, and most of them have higher education credentials (Grindle 2010, 21). Yet another one is due to the introduction, improvement, and enforcement of legislation on formal career civil service systems in the major countries of Latin America (Grindle 2010, 6).

The selection and promotion of civil servants in Brazil and Argentina should reflect the logic of legislative delegation and control of the bureau in each country. Their civil service should reflect the nature of the principal agent problem of control determined by the degree of separation of powers and affected by the specific way in

which the electoral system and multipartism work in each country, as explained in the previous sections. With the previous description as a background, the following pages turn to an analysis of the use of political appointments and career systems in their respective civil services.

Civil Service in Brazil

Throughout the twentieth century, patronage was used by Brazilian presidents, both military and democratically elected (Grindle 2010, 11). Since the return of democracy, political appointments at the highest levels of government have been often used for party coalition-building, as discussed in previous sections (Barreiro Lemos and Llanos 2006, 12-14). Additionally, political appointments have been extensively used to bring qualified officers to the government for upper and middle level positions that are considered ‘confidence’ posts (Grindle 2010, 9).

Even if positions officially available for political appointments represent only 9% of public sector employment, there are significant differences between *de jure* and *de facto* practices. In fact, political appointments have been made down to the level of unit chiefs, which are located at the middle range of the public administration (Grindle 2010, 5). In some cases, political appointments to temporary or non-career posts have been granted tenure and protected from arbitrary firing (Grindle 2010, 11).

Since the PT has been in power, key positions in the federal government have been filled with political appointees belonging to unions (D’Araujo 2009, 57). This is consistent with the presence of union-related parties in the government coalition of President Lula da Silva. These key positions include ministers (almost exclusively filled with PT members) and ‘managerial’ positions just below ministerial level (D’Araujo

2009, 45; 124).¹⁹⁵

In Brazil, a career system in charge of implementing and monitoring examinations for entrance into the civil service has existed since 1937. Initially, it was perceived to respond to president Vargas who introduced it. In effect, the president used it to centralize control over the bureaucracy and to professionalize the lowest ranks of the civil service, where patronage was a more widespread practice (Grindle 2010, 8).

Initially, only a quarter of federal positions were filled through this system. However, career civil servants increased as a proportion of civil service over the decades reaching positions not only at low levels, but also at middle levels in the government (Grindle 2010, 9-10). Over time, the career system became open for recruitment and meritocracy. Mechanisms for entrance, promotion, and non-arbitrary firing have been established on the basis of merit and performance (Iacoviello 2006, 543).

In the 1990s, president Cardoso sought to reform the public sector. The reform was designed to replace a system that combined bureaucratic administration with clientelist/patrimonial practices with one that would follow the principles of the ‘new public management’ model (Bresser Pereira 2003, 6). It included limits on tenure and salaries of high-level career civil servants; decrease in privileges for those who had positions in the career system; as well as promotion of ‘managerial’ and ‘entrepreneurial’ criteria in the civil service (Grindle 2010, 12).

To summarize, stability and professionalism have characterized much of the civil service from the 1930s to the 2000s, regardless of whether its members are political appointees or recruited through competitive process. Indeed, the country is one of the

¹⁹⁵ For a further discussion on political appointments under President Lula da Silva, see D’Araujo (2009).

best examples in the region of a civil service with some autonomy from politics (Evans 1989). Political appointments at the high level reflect coalition building. It is worth recalling here that the electoral system creates insufficient legislative support of the president (Cardoso and Graeff 2012, 32). As a result, the president needs to build legislative alliances with numerous parties. In order to maintain the alliances, the president needs to appoint members of allied parties to the cabinet (Cardoso and Graeff 2012, 30). An interesting example is the appointment of Michel Temer from the PMDB as the vice-president of President Rousseff from PT in 2011.

Other appointments at the high/middle bureaucratic levels respond to the need for trustworthy collaborators in the executive sphere. Despite these positions being filled with career public officers, they are non-permanent. Appointees may answer to the president or to members of the cabinet that belong to the parties in the coalition. Thus, the control over these politically appointed bureaucrats is shared between the president and other members of the government coalition. Officers in the career system enter and get promoted within the bureaucratic structure based on merit criteria. These positions are permanent and officers answer to *interna corporis* structures, under high bureaucratic discretion, governed by administrative procedures, and subject to *ex post* controls from the legislative¹⁹⁶. In addition to this, political appointees at low/middle level positions are usually incorporated later as permanent non-career officers.

Hence, numerous political appointments are a manifestation of controls typically found in presidential systems. In Brazil, they answer not only to the president like in the United States, but also to the government coalition. On the other hand, the process

¹⁹⁶ Obviously, in addition to legislative oversight, the president has its own executive controls over the bureaucracy.

wherein career bureaucrats are controlled *ex post* by Congress is closer to the way in which parliamentary systems recruit, delegate, and control civil servants. These parliamentary features where the government coalition in Congress exerts substantial authority in all aspects of government stem in Brazil from elections ruled by proportional representation and open lists and a multiparty system.

Civil Service in Argentina

Prior to the 1990s, the largest number of public officials in Argentina was appointed and had careers in the public sector under the discretion of their patrons during military and democratic governments alike. The major criterion for appointment was partisanship¹⁹⁷ for upper, middle, and low positions.

After several attempts of public sector reforms, certain limits have been established to this system in Argentina. Political appointments should officially reach down to the lowest level of political positions (sub-secretaries and directors) representing no more than 0, 4% of public sector employment. However, *de facto* practices have been different (Iacoviello and Tommassi 2002, 42).

Political appointments to the cabinet and at first level sub-cabinet positions answer to the executive, who are the president and ministers. Other high level officials may appoint officers and advisors at high/middle bureaucratic levels. These often have temporary and renewable contracts funded by extra budgetary sources including loans from international organizations. In fact, thousands of employees have been contracted through projects funded by multilateral banks and other international organizations.¹⁹⁸

¹⁹⁷ Or loyalty to the regime.

¹⁹⁸ Argentina was the country of the region that had used more intensively this practice (Oszlak 2001, 13).

They accounted for 16% of the federal government employment in 2002 (Grindle 2010, 12-14). Moreover, temporary contractual employees have been mostly assigned to central departments of the state, such as revenue or regulatory agencies (Iacoviello and Tommasi 2002, 89). These employees answer to the need of trustworthy collaborators often for the advancement of policy agendas that the executive has committed to advance. This group of officers can constitute truly parallel structures within the public bureaucracy at the service of the executive and beyond any congressional oversight practice.

Employees in low/middle level positions often get permanent non-career posts after one year of service and are protected from dismissal by workers' rights legislation (Grindle 2010, 9-10). These positions are usually under the control of the public sector unions responsive through the dominant party to the president.

In Argentina, a career civil service system was created in 1973, but recruitment by examination was suspended. In 1987, a corps composed of officials who were to serve as managers across government was established. This service also gradually lapsed over time. There have been some professionalized bodies inside the public sector, whose staff have been recruited and promoted on merit-based criteria, such as the Foreign Service and the technology institutes *Instituto Nacional de Tecnología Agropecuaria* (INTA) and *Instituto Nacional de Tecnología Industrial* (INTI) (Iacoviello and Tommasi 2002, 14).

In the 1990s, the reform of the state also reached the civil service. The objective of the reform was to create a simpler and clearer career system, one based on the criteria of tenure and merit. Promotions would follow competitive processes based on time in position, annual performance review, and training. Previously in a position of strength, unionized public employees were the losers of the reform. The most powerful unions had

to support the new career system as a way to ensure jobs for some of its members. The new system was created, covering 40 percent of federal government employees at the time (Grindle 2010, 13-14).

In 2000, recruitment through this merit system was again suspended (Grindle 2010, 13-15). Since then, political appointments have been used in areas that are usually filled with career civil servants such as the Foreign Service (Iacoviello and Tommassi 2002, 43).¹⁹⁹ Even if there have been rules and procedures to prevent arbitrary and political decisions in career civil service, there have been gaps between regulations and usual practice. At the implementation level, political criteria have arisen in some cases and predominated in others (Iacoviello and Tommassi 2002, 42).

To summarize, the civil service in Argentina is a complex system composed of non-career tenured officials, career officials, a fading body of government managers, and numerous temporary employees, adding up to 'parallel bureaucracies'. With the exception of resilient bodies of professionalized and tenured civil servants, initiatives for the development of a comprehensive career system have been disruptive. However, career systems have been usually a decision of the presidents.

Hence, the extensive use of political appointments at every bureaucratic level and career systems repeatedly initiated by presidents demonstrates control of the bureaucracy in the hands of the executive. In effect, delegation of authority to and control of civil servants are responsive to the president. Moreover, this type of recruitment includes political appointees who later get tenure through unions affiliated to the dominant party,

¹⁹⁹ These appointments have been put in practice by means of decrees of exception that authorize transitory appointments of duration of 180 days (Iacoviello and Tommassi 2002, 43).

but who also answer to the president. Slight elements of high discretion and *ex post* control, like in parliamentary systems, can be found almost exclusively in specialized agencies. This dominating power of the president over all aspects of government stems in Argentina from elections ruled by proportional representation and closed lists and a single party that dominates the multiparty system.

To conclude, political appointees and career officials coexist in the civil service of Brazil and Argentina. However, some differences can be pointed out across systems. Brazil shows a combination of presidential and parliamentary elements of legislative delegation and control over the bureaucracy in the selection and promotion of their civil service, which serves predominantly the interests of unstable government coalitions while assuring at the same time stability in the bureaucratic sphere. Further, the typical instability observed in presidential systems governed by multiparty coalitions is partially compensated in Brazil by a more stable bureaucratic system. Argentina demonstrates presidential and parliamentary elements of legislative delegation and control over the bureaucracy in the selection and promotion of their complex and erratic civil service system serving the interests of the president, who normally belongs to the party that dominates the political system. In other words, the fragmentation and disarray of the bureaucratic system is partially compensated for in Argentina by the concentration of its political system.

8. Conclusion

This paper has addressed the issue of how delegation of authority to and control over the bureaucracy are affected by the way in which electoral and multiple party systems determine the separation between legislative and executive powers in presidential systems. To do so, the paper has evaluated the methods of legislative control over the bureau practiced in Argentina and Brazil in comparison to the U.S. case.

This topic has been well studied for the presidential system of the United States. However, the comparison of Brazil and Argentina to the United States and the explanation for the differences in control of the bureau across the three presidential systems have not been well investigated. This paper argues that the explanation lies in the way electoral and party systems work in each country.

In the United States, legislative control over the bureaucracy is based upon two main elements: detailed administrative procedures in legislation that reduce *ex ante* bureaucratic discretion, followed by ‘ongoing’ and *ex post* budget controls that reward and sanction bureaucratic activity. The design of the policy process contained in detailed legislation allows for the participation of interest groups, who have incentives in providing Congress with information about bureaucratic activity. This structure is complemented by secondary control tools such as confirmation of appointments, commissions of enquiry, and external audits as well as impeachment in exceptional situations.

This results in a ‘system’ of legislative control over the bureaucracy that remains autonomous from the executive, consistent with separation between legislative and executive branches in the U.S. presidential system of the division of powers. This *de jure*

separation between powers and purpose of the executive and legislative branches is complemented by a plurality rule electoral system that is biased against coalition government, and which does not therefore offer opportunities for the president to extend his or her control to the legislature, or for coalition members to encroach on the power of the president as a price of maintaining effective presidential power while in office. Thus, the U.S. system of legislative control of the bureaucracy is a reflection of the U.S. electoral and party systems.

Despite both having formally adopted central features of the U.S. presidential system, legislative control of the bureau in Argentina and Brazil demonstrate important differences.

None of the key elements underlying the U. S. system are important mechanisms in Argentina. Legislators in this country have neither the resources nor the incentives to include *ex ante* controls inside legislation. The budget process has never shown potential as a control tool because of limited periods of economic stability. Interest groups do not benefit from providing information about bureaucratic activity to Congress in Argentina. One of the most important contributions the legislature has made, in terms of overseeing the bureau, is the approval of administrative reorganization bills. This control tool, common in parliamentary systems, is practiced in Argentina by the president. In an attempt to temper the presidential system, other parliamentary features of control have been recently introduced or enhanced, such as external budget controls.

Thus, control over the bureau in Argentina is more political than legislative, in the sense that it is performed by elected politicians and not exclusively by legislators. In effect, legislative authority to the bureaucracy is delegated not only by Congress, but also

by the executive that has extensive legislative powers. Control over the bureau is performed by both branches of power concentrated under the president. In other words, the president that dominates the two branches of government (the dominant principal) delegates authority to and controls the bureaucracy (the agency). The relation between the legislative and executive powers that includes elements of subordination of the former to the latter is attained through elections ruled by proportional representation and closed lists and a multiparty system with one dominant party. This allows party leaders of the dominant party to be assured of legislators' obedience in Congress and of their support to the president. In short, if the president belongs to the dominant party, which has occurred over the last 25 years; legislative control over the bureaucracy constitutes control in the hands of the president.

In contrast to Argentina, Brazil partially follows the U.S. model of legislative control of the bureaucracy. Elements widely used in the United States coexist with common parliamentary features. On the one hand, the government coalition in Congress controls the executive with tools commonly found in the U.S. presidential system, in addition to impeachment when serious misunderstandings arise between them. On the other hand, Congress controls the bureaucracy wherein many high ranked officials are career civil servants, and it uses *ex post* methods of control common in parliamentary systems.

This dual model of control is consistent with a presidential system in which a multiparty coalition in Congress constitutes the ground upon which the executive stands, temporarily approaching the two branches of power. Legislative oversight of the bureaucracy is performed by the government coalition. Legislative authority is delegated

by Congress to the bureaucracy. The president has considerable legislative powers, but the government coalition also penetrates the executive by means of their representatives in cabinet. In short, the government coalition in Congress (the principal) uses delegation of legislative authority and control to oversee the bureaucracy (the agent) as well as to manage support and negotiation with the president. As long as the government coalition in Congress remains unchallenged, it assures a high level of discipline amongst the majority of legislators to the coalition and legislative support to the president. This relationship between the two branches of power is attained through elections ruled by proportional representation and open lists and a multiparty system.

The electoral and party systems make legislative and executive branches of power separate in the United States, intertwines them in Brazil, and subordinates the former to the latter in Argentina. Legislative control methods over the bureaucracy are in the hands of Congress in the United States, of the government coalition in Brazil, and of the president (from the dominant party) in Argentina. Legislative control over the bureaucracy is a reflection of the electoral and party systems in the three countries.

The first conclusion of this study is that the application of the United States model of legislative control over the bureaucracy to Argentina and Brazil is of limited analytical utility, even though both these presidential systems were originally created in its image.

The second conclusion is that legislative oversight of the bureaucracy in Argentina and Brazil works differently despite formal constitutional similarities and historical and political resemblances. Legislative control mechanisms in Brazil are more similar to the U.S. model than to that of Argentina.

A third conclusion is that electoral and party systems can create conditions that affect the nature of legislative control of the bureau. Presidential systems formally grant Congress specific formal tools to oversee the bureaucracy. However, the actual causes for differences between countries in the nature of legislative oversight can, in the cases we have studied, be traced at least in part to differences in the way electoral and multiparty systems and multiparty coalitions in government work.

The U.S. system is frequently used as a reference for the study of Latin America and the differences found in developing countries are often presented as ‘exceptions’ or ‘anomalies’. The conclusions of this work suggest that the ‘exceptional’ structures of control found in Latin America emerge or are conditioned by broader, systemic electoral and party forces.

Finally, it is worth highlighting that control mechanisms designed for a separation of power system and applied where powers are closer or concentrated amongst a few political actors, may disable the checks and balances planned for presidential systems. This likely has consequences for democratic accountability. So, the link between the *effectiveness* of legislative control and government accountability and its relation with electoral and party systems offers venues for future research.

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Appendix 3.1: The United States

The U.S. Legislature: Committees, Parties, and Legislative Powers of the Executive

The legislative branch in the presidential system of the United States is more powerful and independent in terms of the executive, compared to parliamentary systems. Its main inter-partisan institutions are the House of Representatives, the Senate, and the committee system. Due to the U.S. bipartisan system, the authorities of the democratic and republican parties are the main partisan institutions in Congress ²⁰⁰.

In the United States, legislators are elected by means of a plurality/majority system, usually called 'first past the post'. The candidate who obtains the most votes wins, regardless of the absolute majority of votes. Electoral districts are single-member constituencies. Voters vote for candidates rather than parties (www.idea.int, accessed September 27, 2015).

The House of Representatives is composed of over 400 legislators from relatively small districts. Their mandate lasts two years. Therefore, they often find themselves involved in re-election campaigns, seeking to satisfy the needs of their voters and districts. Such conditions often allow local or regional interests to come before larger national interests. The Senate is composed of 100 senators who represent 50 states. They answer to larger districts and generally serve national interest groups as opposed to the House of Representatives, wherein local interests preside. The mandate of senators lasts

²⁰⁰ Other partisan institutions are the whips and the caucus system. The role of the (majority and minority) whips is to maintain discipline amongst party members regarding important votes, carry out surveys on voter intentions and pass on information to the leaders. The caucus is a subgrouping of legislators with similar political interests seeking to advance them by promoting legislation or putting pressure on agencies so as to obtain a given treatment. Belonging to a caucus offers many advantages to legislators, including low affiliation cost and benefits in terms of election campaign funds, access to executive power and to party leaders (Loomis et Schiller 2004, 182).

six years. Consequently, they are less frequently involved in campaigning. Party leaders have less control over legislative work in this particular house. These factors encourage deliberation, consensus, and compromise by compounding interests within the legislative decisions of senators.

The committee system has an important impact on legislative activity. The division of labor according to different committees is particularly important within the House of Representatives because of its size. Committees receive government bills to work on, in order to convert them into official laws. Each committee has a permanent status, fixed members, rules, staff and budget, as well as a jurisdiction defined by the designated legislation for the committee to work on. Committee leaders have the power to control the program of the hearings and choose the personnel for each committee. Additionally, the legislature disposes of over 2000 permanent employees (Lowi, Ginsberg et Shepsle 2006, 103) and supportive units namely the General Accounting Bureau, the Congress Budget Bureau, the Library of Congress, the Capitol Police, and the Office of Complaints (United States Congressional Budget Office 2008).

The political parties are the master builders in terms of organizing Congress and the direction of legislative activity. The most important leaders are the speaker, the majority and minority leaders, and the committee leaders. The speaker is the principal authority of the House of Representatives. He presides over the house, designates the most important committee members and assigns bills to each committee. The leader of the majority – along with the speaker and members of the regulation committee in the case of the House of Representatives - establishes the calendar for parliamentary debate, assigns members of its party to committees, and negotiates with the opposition party and

committee leaders on legislative procedures. The minority leader presents its party project to the houses and reverts to procedural techniques during debates (Loomis et Schiller 2004, 182). Yet, party leaders of the U.S. legislature do not have any particular role to play in conflicts between legislative and executive authorities, as opposed to parliamentary systems where presidential party leaders are its negotiators at the parliament (Loomis et Schiller 2004, 9).

In the United States, the re-election rate of legislators is historically very high, above 90% for representatives and above 80% for senators (Loomis and Schiller 2004, 66- 67). This means that the election campaign is very much a part of their activities, in particular for those representatives whose mandate represents only one third of that of the senators. Thus, the relationship between legislators and voters is very close within their respective districts. It shows up in the fragmentation of interests represented in Congress as well as in voter contribution to legislator funding in election campaigns (Loomis and Schiller 2004, 70). The consolidation of this relationship has benefitted from legislator relations with bureaucracy as well as from the committee system. This system offers easy access to those that wish to influence the legislative process (Fiorina 1977)²⁰¹, and explains the role that interest groups play in bureaucratic design and decisions along with oversight. All this offers tools for obtaining votes and re-election to legislators who are already Congress members rather than to new candidates. Consequently, legislator election campaigns and successful elections depend on the support of the voters rather

²⁰¹ This influence has been analyzed in the literature on ‘iron triangles’. This concept describes the relations between the legislature, the bureaucracy and the interest groups. Generally, the three triangle summits are represented by the Congress committees responsible for the surveillance of certain industries, Federal agencies responsible for the regulation of these same industries along with the industries themselves and their associations (McConnell 1966).

than on that of the party. This shows up in partisan discipline, which is rather weak in Congress (Lowi, Ginsberg and Shepsle 2006, 108-109).

The legislative attributes of the executive are designed so that no member of Congress can affect the legislative process more than the president. The latter has control over the legislative agenda and the federal budget, as well as veto power to establish coherence in collaboration with legislation, policy administration and budget decisions (Loomis et Schiller 2004, 112).

Most of the legislation originates from executive power. However, the latter cannot present a project directly to Congress. It can, however, seek out a legislator with influence who can introduce it to the corresponding committee. Indeed, the presentation of a bill implies its official submission to respective houses by a senator or representative. After its presentation, the project is submitted to the appropriate committee for deliberation. If the committee approves of the project, it is ready for the next stage. Only 15% of them are successful in moving forward (Lowi, Ginsberg and Shepsle 2006, 104). This is consistent with a specific feature of presidential systems mentioned earlier: wherein the *status quo* is protected and new law making is difficult. A project presented to the House of Representatives must move beyond the regulations committee, which has to determine the time and possibilities for amendment during the assembly debate²⁰². At the Senate, the time for debate and possibilities for amendment are unlimited. Hence, a minority opposed to a project can prolong the debate without allowing votes to take place. Once the bill has moved successfully during the voting stage through both houses, it is sent to the president.

²⁰² A project can 'die' at this stage if the committee does not establish these rules.

If the president signs the project, it can then become a law. However, the president can also oppose its executive veto and send the project back to its original house, along with his objections. The leaders of both houses can only override the veto on the bill modified by the president if they have 2/3 of the votes from each house (Loomis and Schiller 2004, 115).

The president can establish political priorities in a centralized fashion through the federal budget, and control them with the help of the Office of Management and Budget (OMB). The latter can also make budget proposals for each program and establish the details on spending the budget. However, its influence over budget is only partial, due to corresponding legislative control.

As opposed to parliamentary systems where the cabinet is composed of legislators from the majority party, the U.S. constitution does not allow legislators from the presidential party to be appointed to the executive. Ministers cannot participate in legislative debates either, although they can witness Congress hearings (Cox and Morgenstern 2001, 460).

Legislative Oversight over the Bureaucracy in the United States

In the context of a presidential system, the Congress delegates authority to the president so that he may choose the best ways to enforce legislative decisions in the departments and agencies of public administration (Lowi, Ginsberg et Shepsle, 2006, 95). As previously mentioned, this delegation of legislative authority increases the power of the president and bureaucracy and explains the motivation of Congress behind legislative control. The main tools for legislative oversight of the bureaucracy that the U.S. Congress

relies on are legislation, confirmation of executive appointments, enquiries, impeachment, and the budget process.²⁰³

Detailed legislation (Cotter, 1967, 31) is the most frequent method used by the U.S. Congress (McCubbins et al 1987, 244) to control the bureaucracy by determining objectives, criteria, and specific tasks to be performed. U.S. legislators tend to use precise and specific language to establish detailed administrative procedures, offering low discretion to the bureaucracy in policy administration. Legislators also tend to allow for the participation of interest groups in policy making (McCubbins et al 1987, 274; Bawn 1995, 63; McCubbins and Schwartz 1984, 173). A procedure could, for example, include agency obligation to inform Congress as to the different stages of the administrative process. It may also include the right of voters to be consulted during rule making and access to information during policy implementation, the exemption of control over certain interest groups, the determination of groups who will carry the burden of proof, and *sunset provisions*²⁰⁴. Thus, politicians can ‘stack the deck’ by establishing situations where political actors can control details of administrative procedures linked to specific public policies. In other words, detail control ensures that the influence of different interest groups in policy decision-making is not hazardous and that the benefits of bureaucratic decisions on policies go to the same interest groups who benefited from the

²⁰³ The U.S. Congress used to have the Right to Veto certain decisions of Public Administration (Cotter 1967, 32). This instrument used to serve in terminating Power delegated to the Executive or disapproving of his particular manipulation of Power or that of his agents. Until relatively recently, the U.S. Congress used this control method. However, the U.S. Supreme Court held that the Legislative Veto was Unconstitutional in *INS v. Chadha* in 1983. The Court made it clear that once Congress had made its choice to enact Legislation, its participation ended. Congress could thereafter only control the execution of its Enactment indirectly, by passing new Legislation and highlighting the pre-eminence of Law as a control mechanism. Since then, ‘report and wait’ Provisions and Requirements have been used before action is undertaken (CRS Annotated Constitution 2015).

²⁰⁴ This requires a deadline or conditions that, once met, can determine that certain actions, decisions or mandates, are no longer current unless legal action is undertaken to ensure their continuity.

political negotiations that engendered those policies (McCubbins, et al 1987, 261). Further, the design of administrative procedures may allow certain interest groups to ‘sound the alarm’ (McCubbins et Schwartz 1984, 173) and inform Congress when bureaucratic decisions stray from legislative objectives. Accordingly, agencies and departments make decisions in favor of key interest groups simply by following the law.

The confirmation of government officials appointed by the president represents another mechanism of control. The executive has the power to designate ambassadors, consuls, ministers, judges of the Supreme Court, other federal judges, military officers, and all other officers of the United States. However, the president must obtain the confirmation of these appointments from the Senate (Lemos and Llanos 2006, 11). This represents a form of “pre-control” because, even if the Senate rarely refuses a nomination, the debate on the matter serves as a reminder as to the limits of the president's power (Cotter 1967, 46-47). The procedure of designating nominees includes a review of their qualifications and a confirmation audience, wherein the Senate can question the nominees on the policies they intend to pursue. The nomination can be accepted, refused, or conditioned by the majority of the Senate, so the process is an opportunity to negotiate on matters other than nomination. For this purpose, senators count on the *holding* tradition that allows retaining the nomination under any circumstance for an undetermined period of time, rather than refuse a nomination (McKenzie 2002, 30; Lowi, Ginsberg and Shepsle 2006, 115).

Commissions of enquiry represent another technique to control the bureaucracy. Their objectives include amongst others: supplying Congress with quality information on decision making; inhibiting abuse of power; checking for compliance within agency

operations according to legislation. Individual legislators or Congressional staff can lead enquiries. However, the committees of both houses²⁰⁵ are responsible for periodically reviewing the execution of the laws that correspond to their jurisdictions as well as program and policy performance. For this purpose, they are entitled to assign witnesses to appear before the courts, question and make accusations on their refusal to cooperate (Lowi, Ginsberg and Shepsle 2006, 114).

Impeachment, or penal sanction, is a last resort instrument to control, reserved for severe circumstances, when all other forms of control have failed. This procedure implies the judgement and possible discharge of the authority in question and applies to the top levels of executive power²⁰⁶, in particular the president and vice-president (Cotler 1967, 43; Lowi, Ginsberg and Shepsle 2006, 116). The house of representatives is the body that can trigger impeachment while the Senate acts like the judge. The mere existence of such an instrument introduces the power of deterrence into the Congress, regarding potential executive behavior going beyond acceptable boundaries.

As to control techniques focusing on the budget, Congress has three complementary methods at its disposal: approval; authorization, and appropriation. In terms of approval, the Congress has the power to pre-approve, approve and evaluate the federal budget presented by the Executive. It can influence the budget policy overall and determine priorities between different national programs, as well as ensure that legislation on income, expenses and debt conforms to general budget policies. From an institutional perspective, the key Congress institutions to carry out the task are the Senate

²⁰⁵ Except for Appropriation Committees

²⁰⁶ As well as the power of the Bench.

budget office, the House of Representatives budget office and the Congressional Budget Office (CBO). Once their work is done, each house must prepare a submission for debate and vote on the bill, which will regulate federal budget policies.

Of course, each year the approval of the federal budget impacts the complementary phases of authorization and appropriation of federal funds. The procedure of authorization allows the legislature to create programs in public administration by granting them authorization status to funds without guaranteeing their appropriation. This represents the first level of legislative control called the 'power of the purse'. It allows legislators to oversee agency work as well as control their programs in order to authorize them (Kaiser, Oleszek, Halstead, Rosenberg and Tatelman 2007, 22).

Finally, the process of appropriation is one of the most important control methods. The appropriation committees of both houses are the institutions in charge of appropriating federal budget revenues to support public administration activities and cancel pre-authorized revenues as well (Kaiser, Oleszek, Halstead, Rosenberg and Tatelman 2007, 23). Most programs and agencies are under scrutiny each year during committee hearings, which must examine and approve the budget requirements of every agency within the federal budget. Committee decisions are conditioned by estimates as to the budget requirements of each agency, as well as by its previous performance. Hence, committees are authorized to evaluate programs and agencies in detail and reduce or increase funding accordingly (Lowi, Ginsberg and Shepsle 2006, 114). Budget control through appropriation therefore represents a form of legislative sanction and reward for bureaucrats and their units.

Other institutions in Congress are responsible for budget control, such as the General Accountability Office (GAO) and the CBO mentioned above. The GAO supervises federal programs by way of reports, testimonies, legal decisions and opinions. All government expenses must be checked by the GAO, which also evaluates the corresponding work of the treasury department. In order to carry out this mandate, the GAO has access to information related to any operation performed by public agencies for the purpose of investigation (Ingersoll, O'Connor and Pecorella 1993, 73). The main authority figure in the GAO is the controller general who is appointed by the president, subject to approval by the Senate²⁰⁷. The CBO prepares a document on budget priorities, determining revenues and expenses that must be approved by both houses of Congress. That document forms the basis for legislation related to revenues and expenses. The CBO presents the Congress with information on budget scenarios, thus allowing party leaders and committees to choose from alternatives. Those proposed by the Office of Management and Budget (OMB) depend on executive authority (Loomis and Schiller 2004, 120; Lowi, Ginsberg and Shepsle 2006, 103). The principal authority presiding over the CBO is the director, who is chosen by authorities in Congress, in accordance with the budget committees of both houses. The legislature allocates various budget resources for these agencies to carry out their mandate. The CBO hires 230 employees thanks to an annual budget of \$37 million. In 2007, this allowed it to draft 46 reports, 12 monthly magazines and 14 publications along with additional information, and testify before the Congress 29 times on different subjects (United States Congressional Budget Office 2008). As for the GAO, it has 3120 employees along with an annual budget of approximately \$500 million. Additionally, 82% of the recommendations made between

²⁰⁷ He or she can only be discharged with the consent of both houses.

2002 and 2007 were carried out.²⁰⁸ The joint budget of both agencies appointed for legislative control is equivalent to 0,004% of the GDP of the United States.

²⁰⁸ According to the GAO (2008), this led to economic benefits representing a return of 94 dollars for each dollar invested into the Budget. Thus, the Joint Budget of both Agencies appointed for Legislative Control is equivalent to 0,004% of the GDP of the United States.

Appendix 3.2: Legislative Prerogatives of the President in Argentina and Brazil

Presidents can initiate legislation directly without the mediation of a legislator, and intervene to accelerate consideration in Argentina (Constitution of Argentina, art. 77) and in Brazil (Brazilian Constitution, art. 61). In the latter, Congress rarely initiates significant laws (Ames 2002, 139), but constantly proposes amendments, modifies, bottles up, tables, or blocks most executive proposals (Alston et al 2008, 123-7; Ames 2002, 187). Their final approval carries a price in pork, patronage, and concessions to privilege the interests of legislators (Ames 2002, 139).

Total vetoes as well as vetoes per item are constitutional tools in the hands of the presidents both in Argentina (Constitution of Argentina, art. 77) and Brazil (Brazilian Constitution, art. 66; 84). A veto per item allows for the promulgation of a law without the sections that receive the veto, implying preservation of the executive initiative despite legislative changes *ex post* (Mustapic 2002, 31). In Brazil, it is constitutionally easy to override these vetoes, but Congress rarely does it (Alston et al 2008, 125-6).

Presidents are entitled to dictate executive authority decrees in both countries (Constitution of Argentina, art. 100; Brazilian Constitution, art. 62). This is the most proactive legislative tool that allows presidents to make quick decisions and circumvent the legislature (Desposato 2006, 60). This implies an explicit delegation of power from the legislature to the executive. It is worth noting, however, that executive authority

decrees must be ratified later on by Congress and that they are meant for particular circumstances.²⁰⁹

In addition to the influence through the leaders of the governing party in Congress, Argentine presidents can penetrate the legislative process by means of legislators who can become ministers once their mandate reaches its term (Argentine Constitution, art. 72; art. 105; Cox and Morgenstern 2001, 460). In Brazil, presidents can appoint legislators to the cabinet without requiring them to decline their elected office in Congress, (Brazilian Constitution, art. 56) so as to serve as brokers between the executive and the legislature. As mentioned above, these appointments are crucial to building legislative support. Once the number of legislative votes attracted by potential ministers is assessed, the president appoints the cabinet legislators from parties and states closest to the presidential program until a legislative majority is assured.²¹⁰

²⁰⁹ Many executive authority decrees have been issued, reissued, and amended several times in Brazil. The Supreme Court tolerated this practice as long as presidents did not reintroduce decrees rejected by the legislature. However, Congress amended the constitution in 2001 and limited the areas in which the executive could resort to authority decrees as well as the number of their reissues (Alston et al 2008, 125).

²¹⁰ Criteria for cabinet appointments may vary. President Sarney's appointments sought to appease powerful states and party leaders in Congress while President Cardoso's appointments were more professional in his first cabinet and geared toward legislative support in his second ((Ames 2002, 160-166).

Appendix 3.3: External Auditing Institutions in Argentina and Brazil

Argentina : *Auditoría General de la Nación*

The constitutional reform of 1994 in Argentina granted constitutional status to the *Auditoría General de la Nación* (AGN), the external audit institution of public accounts under the authority of the legislative power²¹¹ (Constitution of Argentina, art. 85).

Its status in itself represents an important step in improving legislative control methods over the bureaucracy. Congress determines AGN's budget, structure, and internal regulations. The first minority in Congress elects the AGN president for an eight-year period and is eligible for re-election. Its board is composed of six other directors. The House of Representatives appoints three of them and the Senate three others. Its jurisdiction includes not only the external and *ex post* audit of the national budget, but also economic, financial, and legal aspects of the federal bureaucracy, decentralized public institutions and agencies, and public enterprises. Its powers include overseeing public fund management, determining the criteria for control, promoting the creation of commissions of enquiries, and informing Congress through audit reports, amongst others (Pessanha 2007, 20).

In 2014, the AGN controlled resources comparable to 0,05% of the federal budget along with 1350 employees, most of whom have permanent status, to carry out its mandate. The AGN audited 200 million pesos of public expenditure per employee that year, which represents an improvement in performance. In 2002, the institution counted on approximately 400 permanent and 400 contractual employees and audited 100 million

²¹¹ The AGN was created in 1992 by law 24156. The same law created the *Sindicatura General de la Nación*, the internal audit institution under the authority of the Executive Branch.

pesos of public expenditure per agent (Auditoria General de la Nación 2015).²¹² The AGN audits the Administración Nacional de la Seguridad Social (ANSES), a social security agency whose budget accounts for a third of the total federal budget. It also audits the airline *Aerolineas Argentinas* and the public funds that have been transferred to the company since 2008, the year in which it was re-nationalized. As of then, the AGN has audited and informed Congress annually of maintenance problems related to the Sarmiento suburban train. In 2012, one of its trains crashed and the rail disaster left 52 dead. AGN's reports used to get little publicity and were generally ignored by the institutions who were supposed to use them (Pessanha 2007, 16). However, the reports have been available to the public since 2002 and have constituted judicial proofs in legal pursuits involving public administration, including the one related to Sarmiento trains (Despouy 2015, 1-2).

Despite formal powers and improvements, the AGN's effectiveness remains limited. Although the agency falls under legislative jurisdiction, the executive can reduce its budget (Morgenstern and Manzetti 2000, 40). Moreover, the constitutional reform of 1994 ordered the enactment of a law that rules over and above the AGN, but this mandate remains unfulfilled. According to the constitution, the external control of the budget is in the hands of the opposition party. However, current legislation has allowed the AGN to make decisions according to a simple majority of votes by its seven members. This means that if the president wins a majority in Congress, he/she can interrupt initiatives of the AGN with the votes of the members chosen by the legislators of the governing party (Despouy 2015, 1-2).

²¹² For similar details on the United States, see Appendix 3.1.

Brazil : *Tribunal de Contas da União*

The *Tribunal de Contas da União* follows a court of accounts model from the supreme audit institution, similar to equivalent institutions in France, Germany, Portugal, and Spain. It is composed of nine ministers, six of them nominated by Congress. The three others are nominated by the president and confirmed by the Senate, as already mentioned. The tribunal is entitled to determine its own internal rules (OECD 2012, 74) according to its organic law 8443/92. It deals not only with the accounting and financial supervision of government but also with legal and economic aspects of revenue application. Additionally, it has the constitutional prerogative to determine fines proportional to the amount of damage caused to public funds, so its decisions in this regard can be enforced (Cheibub Figueredo 2003, 185).

The tribunal's budget follows the same procedure of approval as the rest of federal public administration. Congressional consent is required for budget reallocation (OECD 2012, 80-82). Its resources are equivalent to 0,08% of the federal budget. It counts on approximately 2600 officials. Among them, 1500 are external federal auditors qualified through entrance examinations. The number of auditors increased by 50% between 2001 and 2011 (OECD 2012, 80-82). The tribunal has audited the accounts relative to the organization of the World Cup 2014, the Olympic Games 2016, and of the Brazilian state oil company Petrobras, which was recently accused of corruption (Tribunal de Contas da União 2015). Its activities are quarterly and it reports annually reported to Congress (Constitution of Brazil, art. 71).