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Privatization in Latin America

The rapid rise, recent fall, and continuing puzzle of a contentious economic policy

By John Nellis, Rachel Menezes, and Sarah Lucas*

Summary: In Latin America, privatization started earlier and spread farther and more rapidly than in almost any other part of the world. More firms, and larger ones, were sold and more proceeds were raised than in almost any other part of the world. Despite positive microeconomic results, privatization is highly and increasingly unpopular in the region. The core social criticism is that privatization contributes to growing poverty and inequality levels in Latin America—and anecdotal evidence supports the claim. But recent and rigorous studies paint another picture, concluding that privatization has contributed only slightly to rising unemployment and inequality and that it either reduces poverty or has no effect on it. These studies have yet to change the mind of opponents; while privatization may be winning the economic battle, it is losing the political war: The benefits are spread widely, small for each affected consumer or taxpayer, and occur (or accrue) in the medium term. In contrast, the costs are large for those concerned, who tend to be visible, vocal, urban, and organized—a potent political combination. We argue that the right policies and strengthened institutions can go a long way toward balancing efficiency gains with concerns about equity. This policy brief is a preview to the analysis and recommendations on privatization in the second edition of *Washington Contentious: Economic Policies for Social Equity in Latin America,* to be published in 2004 by the Center for Global Development and Inter-American Dialogue.

Privatization swept through Latin America in the 1990s. Following the first ownership changes in Mexico and Chile in the mid-1980s, not long after the United Kingdom's pioneering sales, most of the region's public enterprises—everything from banks, power plants, and telecommunication systems to roads, water, and transport services—were sold off to the private sector. In the 1990s, the accumulated privatization revenues in 18 Latin American countries reached 6 percent of gross domestic product (GDP). From 1990 to 2001, private investment in infrastructure alone in the region totaled $360.5 billion, $150 billion more than the next most attractive region, the East Asia-Pacific. More firms, and larger ones, were sold in Latin America and more proceeds were raised than in almost any other part of the world. The results, according to economic and financial assessments, were positive.

At the same time, privatization has provoked more popular discontent and criticism in Latin America than in other parts of the world: More political opposition, more outrage, more—and more violent—demonstrations against the concept and its real or supposed effects.[1]

* John Nellis is a senior fellow at the Center for Global Development; Rachel Menezes is a program associate at the Inter-American Dialogue; Sarah Lucas is a senior associate for outreach and policy at the Center for Global Development.

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The Pro- and Anti-privatization Views in Latin America

"The good..."

Most technical studies of Latin American privatization conclude that it improves firm performance—profits, operating efficiency, and output tend to rise.

- A recent study covering Argentina, Brazil, Chile, Colombia, Mexico, and Peru found an average increase in profits of around 30 percent in a large sample of privatized firms. Efficiency gains averaged a remarkable 67 percent, and output increases averaged around 34 percent.

Infrastructure privatization—more than half of all sales in Latin America—is shown to improve financial and operating performance in (most) firms, relax investment constraints, extend network coverage and access to it, and generally enhance the quality of services. (See Box 1.)

- In Bolivia, the share of rural towns connected to long-distance telephone service increased from 25 to 33 percent after privatization.
- In Mexico, the waiting time for new telephone connection dropped from 890 to 30 days.
- In Argentina, the number of phone lines more than doubled, from 3.1 million to 6.85 million, after privatization.

In terms of fiscal benefits, privatization has brought a positive flow of funds and reduced public debt to governments in the region through price rationalization, retirement of accumulated debt and elimination of subsidy flows, and increased tax revenues from more profitable and productive private firms.

- In the first four years following sales in Bolivia, the government received $429 million, none of which was derived from sale proceeds. In Mexico, privatization proceeds of about $33 billion from 1984–2000 were used mainly to retire public debt, reduce the fiscal deficit, and increase social spending from 6 percent of GDP in 1990 to 9.5 percent in 2000.

With this record of accomplishment, it is small wonder that economists, finance ministers, and investment bankers rank privatization as a success in Latin America.

"...and the bad"

But Latin Americans in general hold a much less positive view of privatization.

- In 2001, a clear majority of people surveyed by *Latinobarométro* in 17 countries in the region felt that privatization had not been beneficial, and by higher percentages than in previous surveys.[2]
- A follow-up survey in 2002 showed a decline in anti-privatization sentiment in a few countries—Colombia, Peru, Brazil, and Ecuador—but increasingly negative views in Uruguay, Bolivia, Chile, Mexico, Venezuela, and Argentina. In every country, fewer people agreed that "the state should leave economic activity to the private sector" than in 1998.

Infrastructure privatization receives the most criticism, particularly in the electricity, water, and passenger rail sectors. Part of the problem is the perceived loss of sovereignty—that is, the turning-over of what are seen as valuable national assets to multinational firms or to firms based in "rival" neighboring countries. There is also the widespread belief that privatization leads to increased unemployment and steep increases in prices of basic commodities. Third, there is the suspicion that many of the large privatization and concession transactions in the region have been tainted by collusion (of private bidders to reduce the price paid for a firm or concession), fraud, corruption, or simply the incompetence of public officials.

Utility privatization has been particularly controversial in Latin America.

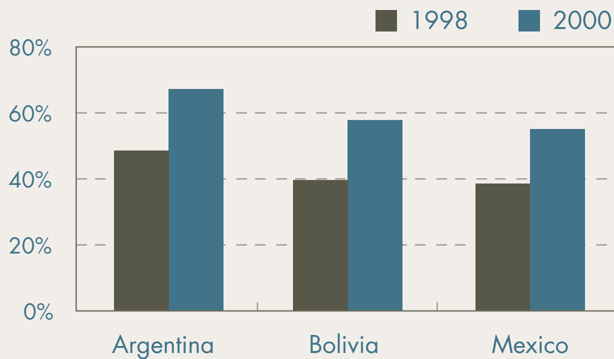
- Violent protests against water privatization and price hikes erupted in Cochabamba, Bolivia—where the concession was cancelled—and against electricity privatization in Arequipa, Peru—where the government decided to abandon the sale. (See Box 2.)

Box 1: Access to Clean Water: A Question of Life and Death

Providing access to clean water and sanitation services is a fundamental challenge in developing countries, one that has significant implications for the health of poor communities, particularly children. Diarrhea accounts for about 15 percent of child deaths worldwide. In Argentina, three waterborne diseases are among the top 10 causes of death among young children. A recent study of privatization of the local water companies in Argentina found that child mortality fell 5–7 percent in municipalities that privatized their water services compared with those that retained public provision. Results were most striking in the poorer locales: privatization of water services led to a 24-percent reduction in child deaths by infectious and parasitic diseases caused by dirty water.

Source: Sebastian Galani, Paul Gertler, and Ernesto Schargrodsky. 2003. "Water for Life: The Impact of Privatization of Water Services on Child Mortality." Unpublished paper.

Figure 1: Percent who disagree or disagree strongly that privitisation has been beneficial



Source: Latinobarométro 2001

- In the Argentine province of Tucuman, popular protests and poor performance led to the cancellation, after two years, of a 30-year private concession for water provision.
- Street demonstrations and burgeoning opposition have led governments to rethink plans to privatize utilities in Panama, Lima, Rio de Janeiro, and elsewhere in the region.
- A port project and a water concession in Argentina (in addition to the one in Tucuman) have been cancelled. A telecommunications operation in Costa Rica has met a similar fate.

Dozens more privatization contracts have been called into question and renegotiated because of unanticipated shifts in market conditions, contract renegotiations by opportunistic private providers, and governmental inability or unwillingness to comply with the contracts (particularly regarding tariff increases). All this, in conjunction with the worldwide economic slowdown, has driven away investors previously eager to bid on infrastructure privatizations in Latin America.

The outcome has been, from 1998 to the present, a strengthening of the critics, weakening support by governments and investors for existing and future privatizations, and a calling into question of privatization's usefulness even by its former advocates.

Privatization's Effects on Poverty and Inequality

The early hope was that efficiency gains from privatization would quickly produce large macroeconomic benefits: improved fiscal health, more jobs, and higher growth. Far fewer of these benefits have occurred than anticipated. In many Latin American countries, the current situation is one of persisting fiscal malaise, higher unemployment, and low growth. This gives ammunition to the critics' claim that privatization has been unfair, that it is a primary contributor to growing poverty and inequality.

Anecdotal evidence supports these claims.

Jobs and wages

It is incontestable that a number of Latin American privatizations have resulted in job losses.

- In Argentina, 150,000 workers were dismissed due to privatizations between 1987 and 1997.
- Approximately 50 percent of all employees in firms privatized in Mexico lost their jobs.
- In Brazil, there was a reduction of more than 90,000 jobs from peak employment levels in privatized railways alone.
- In Nicaragua, privatization resulted in the dismissal of 15 percent of the total labor force.

Critics say this amount of job loss, falling on those whose main source of income is wages, must result in increased income inequality.

Access and prices

Few dispute that price increases in privatized firms are often necessary if the firm is to modernize, meet demand, and operate without subsidies. Under state ownership, many Latin American governments set utility prices at less than cost-covering levels, which led to scarcity, rationing, and firms starved

Box 2: Cochabamba: The Power of a Rotten Apple

Public opinion in Bolivia has been particularly unkind to privatization, partly due to one case that went horribly wrong in early 2000. A water concession to a multinational company in the city of Cochabamba resulted in an average increase in tariffs of 43 percent for poor consumers. This led to massive public protest, including strikes and demonstrations followed by a declaration of martial law in the town and the eventual expulsion of the private firm. The Cochabamba protests gave an organized voice to simmering discontent about unemployment and economic instability in Bolivia. The perceived success of the protests catalyzed ongoing social mobilization and opposition to broader reforms—opposition that recently culminated in national unrest that led to the resignation and exile of president Sanchez de Lozada. The case of Cochabamba illustrates that concerns about privatization can serve as an easy, concrete rallying cry for vulnerable groups in the context of economic reform, and it highlights the importance of managing individual cases of reform to minimize the short-term negative impacts felt by these groups.

of investment capital. But critics claim that in Latin America, the size and speed of the price adjustment has been excessive, with an overly harsh impact on poor consumers. For instance:

- In the short-lived Cochabamba water concession in Bolivia, prices for poorer consumers went up at once by 43% on average, and doubled for a small segment of very poor consumers.
- In telecommunications, "tariff rebalancing" between long distance and local calling generally leads to large price increases in formerly subsidized "fixed line" or local telephone services, while introducing competition—usually producing rapidly falling prices—in international services and through mobile phone systems. Since the poor tend to place most of their calls locally through fixed lines, the price increase is concentrated among the poor.

Sometimes, as in the case of water, the effect of price increases on the poor were offset by provisions such as a "lifeline tariff," where a set daily or monthly amount of initial use is billed at a special low rate. But this scheme overlooks the obstacle to access faced by the previously unconnected poor—the very high connection fees charged by some privatized firms.

- The Buenos Aires water and sewerage concession contract allowed the private operator to charge connection fees of between $1,100 and $1,500 (with payments spread over 24 months) in areas where the average monthly income was $245 per month.

The price of privatized electricity increased in only half of reviewed Latin American cases. But even when post-sale prices fall—as they did in Argentina, Chile, and parts of Peru—the benefits may not be felt, or felt as much, by the poor. Electricity rates may vary according to the locality served or may be adjusted based on the amount of use, with large users receiving a lower rate. Low-income consumers may also be disproportionately affected by price increases in privatized mass transport services (buses), as well as in cases when a negative concession gives private operators an incentive to skimp on service and safety in order to maximize returns—and government monitoring capacity is weak. (A "negative concession" auctions a service to a private provider not on the basis of how much is paid to obtain the firm but rather on how little the private operator will demand from government as a subsidy to run a stipulated level of service with a stipulated fare structure; it has been used in some Latin American transportation reforms.)

Macroeconomic concerns

If governments sell state firms at unreasonably low prices because of incompetence or corruption, or if the proceeds are mismanaged, then privatization could have a negative impact on government finances, on the provision of public social services, and in turn on growth—contributing to poverty and perhaps inequality.

- A study concluded that close to $80 billion in privatization inflows in Brazil in the 1990s substantially "went down the drain in the disarray of public finances," and that inequality was increased.[3]

Overall, and despite a tendency to overlook the distributional shortcomings of pre-privatization arrangements, the argument that privatization adds to inequality has some merits.

The Empirical Counterargument

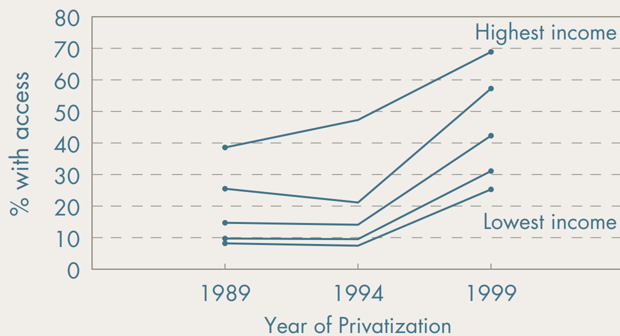
But more recent and rigorous studies paint a much more positive picture, concluding that privatization has contributed only slightly to rising unemployment and inequality, and that it either reduces or has no effect on poverty. These studies expand the lens of examination from the negative short-term impacts on a neighborhood or the employees of a firm, to the longer-term, overall effects on income groups.

- In most cases the numbers of workers laid off due to privatization are small relative to the entire workforce and tend to be offset in the medium term by increased job creation produced in part by privatization and liberalization. General unemployment increases in Latin America came later and were caused by external shocks, labor market rigidities, and financial indiscipline—not just privatization. It has even been argued that privatization may have mitigated unemployment—that is, absent privatization, unemployment levels would be higher.

- Benefits to the poor from increased access trump the costs of price increases. For the poor, often without any access to certain services, the pre-privatization price is infinite. Increasing their access makes them better off. Overall, the positive distributional impact of increased access to privatized utility services outweighs any negative impact of increased tariffs, where indeed the tariffs did actually increase. To illustrate, Figure 2 shows that in Bolivia, access to telephone services increased dramatically following privatization, and additional connections were concentrated among lower-income consumers. Ownership change may not have been the only cause of the pro-poor network expansion, but it is hard to ignore the clear break points in rates of growth that occur in 1994, the year of privatization.

Evidence such as this sways economists and technicians, but it does little to change the negative public perception of privatization in Latin America. The argument is not being fought solely on economic and financial grounds; the reasons for the unpopularity of privatization are also, indeed primarily, political.

Figure 2: Bolivia: Household Access to Telephone Services, 1989–99



Explaining the "Disconnect"

- **Privatization is an easy target.** The foes of liberal reform and globalization find in privatization a simple and visible summation of all they oppose. While the negative results of some liberal reforms are too indirect and unclear to spur active opposition, privatization's costs appear evident. The concept is simple. Costs concentrated among a few can easily be described as costs to society as a whole, and pro-privatization arguments tend to be too complex by comparison. The claims fall on fertile political ground. Anti-privatization movements are numerous and popular in Latin America and receive strong support from trade unions.

- **Overselling the promise; underselling the complexity.** Privatization supporters have often misplayed their hand. Many Latin American governments oversimplified the economic situations they faced and ended up overselling privatization as a key to rapid and sustained growth and social progress. When growth and jobs did not materialize, they were unable to manage the high expectations of consumers and voters.

- **The squeaky wheel gets the grease.** Privatization is a political conundrum. Its benefits tend to be spread widely, among amorphous, unorganized segments of the public; benefits are small for each affected consumer or taxpayer, and they occur or accumulate in the medium term. For instance, a 5–10 percent drop in average electricity tariffs is in the aggregate a substantial and worthwhile gain for any economy. But consumers hardly mobilize politically in favor of a policy or a reforming regime because of such gains, even if it means a few dollars saved in electricity bills at the end of the month. In addition, many of the beneficiaries of privatization's increased access to services are the poor, who had little or no formal access to utilities infrastructure and who are both less organized and more difficult to mobilize. In any case, some consumers, particularly poor ones, probably do not associate gains from reduced tariffs as having anything to do with the privatization of the service.

On the other hand, the costs of privatization are concentrated among a visible, vocal, and usually urban few—dismissed workers represented by powerful unions, bureaucrats who lose authority and perks, managers and board members of formerly state-owned firms, and the middle- and upper-income consumers of subsidized services. Though the sum of their welfare losses may be much less than the aggregate gain, these actors possess "voice" and access to power; they can and do make their needs and views known. They are motivated to do so because the losses for each affected individual are comparatively large and they occur in the very short term. Losses of comparatively large magnitude among stakeholders of this nature typically result in protest, direct political action, or bureaucratic delay and misdirection. The reality is that it is easier to mobilize protest against losses than to engender gratitude for gains, and the gratitude from the awarding of any gain is far less politically powerful than the protest generated by the imposition of an equivalent loss.

- **Public awareness and adjustment programs.** Many liberal economic policy reforms create medium-term, economy-wide benefits but, when implemented, impose costs on some previously benefiting segments of society, who then take steps to protect their interests, often by portraying their loss of privilege as a threat to society. This is not unique to privatization. An effective political system that reconciles the demands for maximizing, spreading, and publicizing the positive outcomes of privatization while acknowledging and addressing the experiences of the vulnerable and sensitive groups is critical.

Conclusions: Making the Most of Privatization

Few public policies have moved in and out of fashion in such pendulum-like manner as privatization. The cyclical process of privatization and nationalization has long been recognized and even predicted: Private provision of utility services eventually leads to conflicts over prices and what is a "reasonable" return on investment. The government then responds with more strenuous intervention and regulation, which eventually decrease returns—causing private operators to quit the market or governments to take over the service. What follows is populist pricing, insufficient investment, and a failure to sustain reform short of ownership, leading to problems of both quantity and quality of service—and provoking once more the increasing involvement of the private sector, first as managers and financiers, and finally as owners. And the cycle begins anew. Privatization events in Latin America from 1980 through 2000 approximated this model.

A prime lesson of this experience is that privatization is but one aspect of liberalizing reform. While there is little real threat of a move toward large-scale renationalization in Latin America, privatization—as with any other liberalizing reform—must be perceived by the public as working fairly and well. That requires embedding privatization in a set of well-functioning legal and economic institutions that promote, monitor, and render transparent market operations. These include:

- definition and protection of property rights;
- contract enforcement and commercial dispute settlement through lawful, peaceful means, and court decisions that are timely and based on the law, not on payments or social precedence;
- independent, well-staffed agencies to regulate the natural monopoly elements of private utilities (and that deliver timely, law-based decisions that are reasonable and credible for both investors and consumers);
- functioning bankruptcy and insolvency regimes for firms operating in competitive markets; and, in general,
- a public administration that meets minimum standards of predictability, competence, and probity.

These institutions provide stability and predictability to market operations, lowering transaction costs. **The more careful and extensive the preparation devoted to the institutional underpinnings of privatization, the better the results, in both efficiency and equity terms** (for example, Chile versus Argentina). Unfortunately, the countries that stand to benefit most from liberalizing reform and privatization are those with the weakest institutions and the most inefficient and corrupt public sectors. In addition, it is not clear exactly what governments, and those that assist them, can and should do to aid the emergence of these policies and institutions and to enhance their capacity. Governments thus face a practical question: Is it better to put efforts into the creation and reinforcement of regulatory agencies to oversee a private provider? Or should efforts be devoted to reforming state-owned enterprises without going so far as to change ownership?

For Latin America, the answer is a continuation of private involvement and ownership, accompanied by expanded efforts to put in place the needed institutional framework. Part of the anti-privatization sentiment in the region stems from a lack of understanding of and appreciation for what has been accomplished. This is combined with a tendency to forget both the poor performance of state-owned infrastructure firms in the past and the very poor track record of performance-improvement attempts that did not involve the private sector. The crucial question has become, How do we strengthen the institutional underpinnings of private participation to better balance efficiency gains with equity concerns? Box 3 outlines recommendations for better achieving this balance.

What is the Washington Contentious?

Washington Contentious: Economic Policy for Social Equity in Latin America is a joint program of the Center for Global Development and the Inter-American Dialogue. The program aims to galvanize attention and political support for a policy agenda that promotes social equity in the midst of economic reform and transition in Latin America. At the heart of the program is the revision of the first Washington Contentious book to take into account the dramatic economic and social change in the region since early 2001, including the financial crises in Argentina and Brazil; the increasing fatigue with fiscal austerity, unemployment and stagnant wages; and the growing public opposition to privatization and other so-called Washington Consensus reforms.

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Nancy Birdsall
President, Center for Global Development

Peter Hakim
President, Inter-American Dialogue

Notes

1 Details of the analyses cited in this policy brief can be found in N. Birdsall and J. Nellis. Center for Global Development. Forthcoming.
2 Latinobarométro is a public opinion survey conducted in 17 Latin American countries by the nonprofit Corporación Latinobarométro, based in Santiago, Chile.
3 Roberto Macedo. 2000. *Privatization and the Distribution of Assets and Income in Brazil.* Working Paper No 14. Washington, DC, Carnegie Endowment for International Peace.

Box 3: Balancing Efficiency and Equity: Policy Recommendations for Privatization to Work Better

Privatization policies and practices crucial to helping governments ensure competition and accountability, protect consumers from abuse, and minimize the risks or levels of damage to the poor and to laid-off workers include the following:

Competition and information

- In the design of privatization contracts and transactions, maximize competition wherever and whenever possible. When the absence of exclusivity (or other forms of monopoly privileges) looks like a deal-breaker, negotiate hard to make the period of exclusion as short as possible.
- Build more transparency into privatization operations by opening bids on television and using independent monitors to vet the transaction and certify its openness and honesty. Make full disclosure a legal part of contract provisions with private providers regarding access, pricing, users' rights, and performance benchmarks. Encourage monitoring and publication of information on service quality by consumer groups, nongovernmental organizations, and the press. Allowing appeal to a technically savvy ombudsman or agency might make sense. The person or agency would be a watchdog for the poor and working class, defending the interests of the bottom deciles and accountable to an elected body.

Special efforts to reach the poor

- When auctioning service provision contracts, build in service obligations on private operators to extend access to poor neighborhoods.
- Subsidies—direct to poor households—could make infrastructure services affordable and would strengthen the voice of the poor as consumers. But such consumption subsidies are difficult to administer fairly; upper-income consumers tend to grab the lion's share. Connection subsidies are an alternative. Subsidizing the high connection costs for water and electricity goes most directly to the poor (the only ones not connected usually), and is a one-time event.
- Build in contractual arrangements between service operators and poor consumers to tap the labor of the poor in service delivery. In Argentina, the low-income population in some neighborhoods is providing the labor to establish and maintain water connections.
- Eliminate regulations that undercut what would be viable markets reaching poor consumers. In Yemen, the government now allows poor communities to tap into already available electricity lines and manage the subsequent distribution and pricing. In other developing countries, eliminating the state telephone monopoly has created a good rental market for mobile phones in poor neighborhoods.

Minimize the losses of laid-off workers—This is politically important because although the number of job losses due to privatization in Latin America is small relative to the entire workforce, they have a very high political cost and help fuel much of the opposition to the reform.

- Make special provisions in privatization schemes to compensate laid-off workers without compromising the government's fiscal position or generating excessive political pressure. Uruguay's state restructuring and modernization program in the 1990s relied on an approach that emphasized incentives and voluntary participation instead of job cuts. Special funds were set aside to cover the severance, early retirement, or transfer costs of employees in redundant positions. These funds also included technical support, business training, and small loans for civil servants who opted to start their own businesses in the private sector. Many of the laid-off employees received training and assistance in finding private-sector employment, and many now provide services to the government—at lower cost—as private contractors. The state restructuring process took place without strikes or labor protest.

Strategy to deal with public opinion

- Complement privatization with public campaigns to explain choices; detail government's priorities within sectors, between sectors, and between instruments; and address concerns regarding privatization strategy, regulatory strategy, and social policy. To ensure public perception of transparency, sales could be addressed separately in public campaigns.

Source: This box is based heavily on the recommendations set out in Washington Consensus: Economic Policies for Social Equity in Latin America, by Nancy Birdsall and Augusto de la Torre, Carnegie Endowment for International Peace and Inter-American Dialogue, 2001.

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1776 Massachusetts Ave., NW
Suite 301
Washington, D.C. 20036

www.cgdev.org

1211 Connecticut Avenue
Suite 510
Washington, D.C. 20036

www.thedialogue.org

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