RONALD COASE INSTITUTE

Working Paper Series

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Working Paper Number 4

January 2004

# Why Is Sector Reform So Unpopular in Latin America?

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**Abstract** Many analysts assume that sector reforms such as privatization of water or electricity are unpopular because prices go up and workers are fired. This paper provides evidence that privatization of utilities is unpopular in Latin America even when everyone benefits: even when prices go down, access expands, workers get valuable shareholdings or opt to retire, and the government meets its target sales price. It suggests that reforms are unpopular partly because the specialists who designed them were not sensitive to the political ramifications of their decisions. A less economically efficient, more politically astute design could be more sustainable.

The paper hypothesizes that design change may not be enough, however. Part of the unpopularity of reforms may stem from the perception by many citizens that they are trapped in an ultimatum game: that even when they gain, the elites unfairly gain much more. If this premise is correct, then sustainable sector reform will depend on broader, tougher institutional reforms to curb corruption, to establish the rule of law, and to increase political and bureaucratic accountability.

**Keywords** Sector reform, privatization, ultimatum game

**JEL classification** O, L9, L33

**Date** January 2004



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**Suggested citation** Mary Shirley. “Why Is Sector Reform So Unpopular in Latin America?” January 2004. *Ronald Coase Institute Working Papers*, Number 4. http://www.coase.org/workingpapers/wp-4.pdf

# Why Is Sector Reform So Unpopular in Latin America?

Mary Shirley*

Anyone contemplating sector reform in Latin America may wonder: why is it so unpopular? Privatization – a reasonable proxy for sector reform more broadly – is widely disliked. Opinion polls by Latinobarómetro (2002) find that about 70 percent of respondents disagree or strongly disagree that the privatization of state companies has been beneficial to their country (Graph 1).[1] Country surveys of Argentina and Peru reach the same conclusion and public protests have led to cancellations of projects to privatize infrastructure in Argentina, Bolivia, Brazil, Costa Rica, Panama, and Peru, among others.[2] Negative views about privatization have increased over time, as experience with reform has lengthened (Graph 2). Country studies suggest that Latin Americans' perceptions of privatization have been strongly shaped by privatizations of infrastructure, which made up more than half of all privatizations from 1990 to 2000 (Nellis 2003), and are reactions not just to ownership change, but to the combination of cost recovery pricing, tariff rebalancing, legal reform, regulatory restructuring, market liberalization, and other changes that constitute sector reform.[3] These adverse opinions raise doubts

* President, The Ronald Coase Institute. January 15, 2004. Final draft of a paper presented at the SCID Conference on Sector Reform, November 13-15, 2003. Send comments to: *mshirley@coase.org*.

[1] Data are taken from Latinobarómetro, which polls a sample of 18,526 respondents in 17 Latin American countries annually.

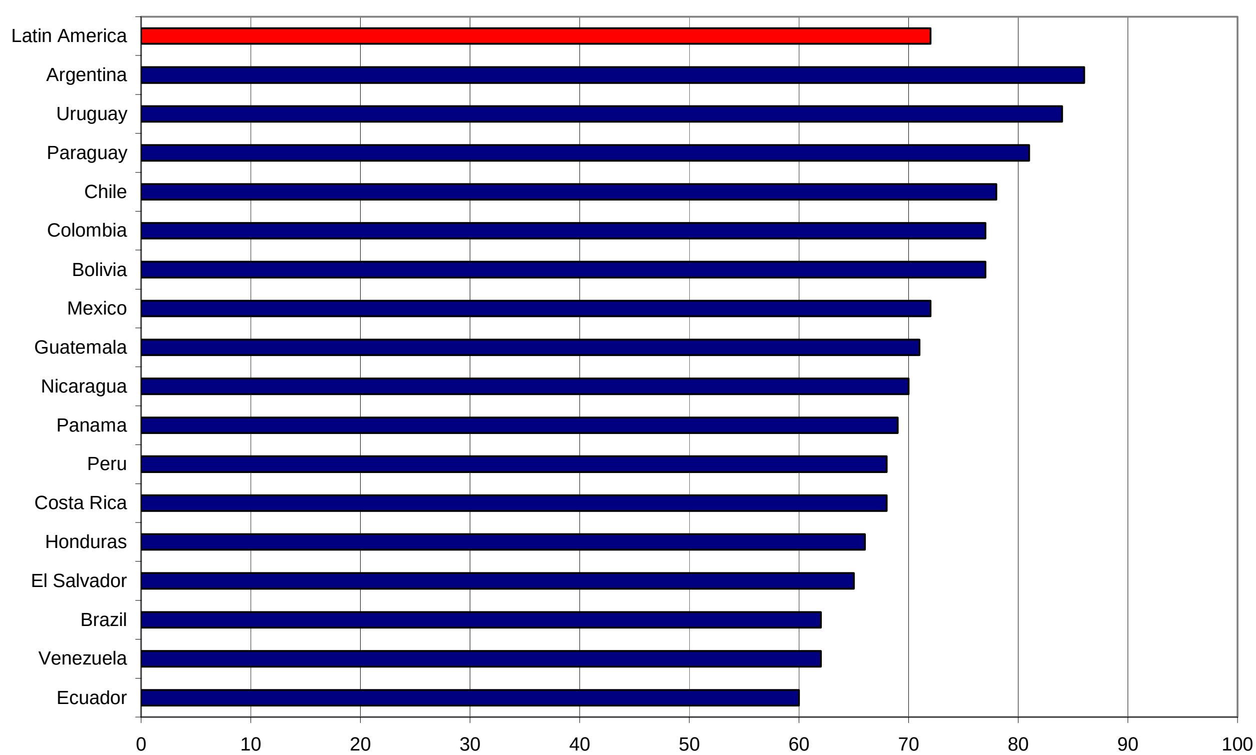
[2] The opinion polls for Peru are from Apoyo, Opinion y Mercado and for Argentina are from Estudios Mora y Araujo, Noguera y Asociados; the information on opposition to privation projects is cited in (Nellis 2003).

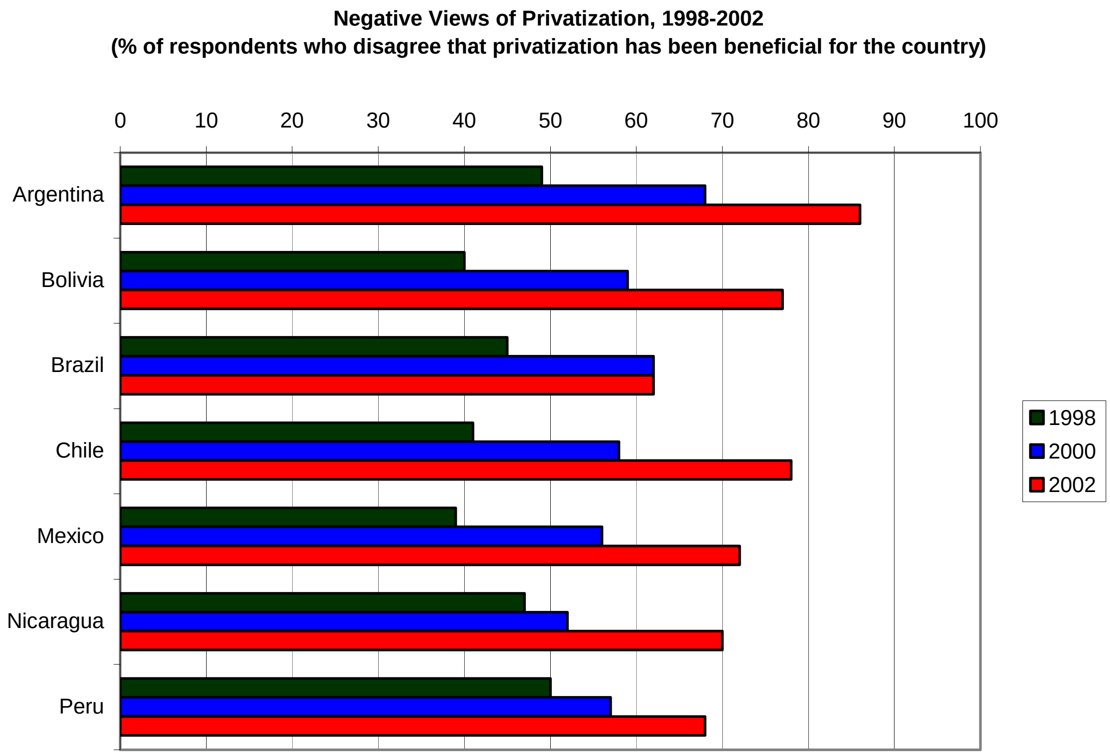
[3] For example, respondents who hold a negative opinion of privatization in Lima cite increases in utility prices and layoffs as its main negative effects. (See for example, Apoyo Opinion Surveys, various.)

about whether future reforms are possible and past reforms can be sustained. For sector reform to have a future in Latin America, reformers will need to understand the sources of dissatisfaction and how – even whether -- they can be addressed.

This essay provides evidence that sector reform is unpopular even when it is beneficial to most actors. This counterintuitive result may occur because sector reforms have not been designed to be politically sustainable; better design may make reforms more politically viable, even if less economically coherent. But dislike of even beneficial sector reforms may have deeper roots. I advance the premise below that many Latin Americans view pro-market reform as an ultimatum game: even when they benefit, they view their gains as unfair because the politicians and business people who decide on the benefits keep a much larger share of the gains for themselves. If this view is correct, then the unpopularity of sector reforms is rooted in deeper institutional failures.

**Graph 1: Negative Views of Privatization, 2002**
**(% of respondents who disagreed that privatization has been beneficial for the country)**






Source: Latinobarómetro, 2002 and information in and Mookherjee (2003).

Some assume that reforms such as utility privatization are unpopular because most people are made worse off. But Nellis (Nellis 2003) reviews a number of empirical studies of the effects of infrastructure privatization in Latin America which all conclude that privatization improved financial and operating performance in most firms, relaxed constraints on new investments, extended coverage and access to services, and generally enhanced the quality of services. McKenzie and Mookherjee (McKenzie and Mookherjee 2003) find that privatization of utilities in Argentina, Bolivia, Mexico and Nicaragua had largely positive consequences for consumers (see table 1). Access went up, dramatically in some cases. True, prices went up in half the cases, but they went down in the other half, and since access increases have a much larger impact on consumer welfare than price increases, the reforms had a largely positive effect on consumer welfare. Sector reforms generally reduced inequality or left it almost unchanged. As for jobs, there were large layoffs in Argentina and Mexico, but layoffs in these capital-intensive sectors had limited impact on economy-wide unemployment, especially over the medium term. Where layoffs were large, a significant percentage of the unemployed were reemployed in the same sector within five years: 45-50% in Argentina and 80-90% in Mexico.

Table 1: Effects of Privatization of Utilities on Consumers

| | ***Change in Access %*** | ***Change in Prices %*** | ***Effects on Consumer Welfare*** | ***Effects on Welfare of Poor Consumers*** | ***Effects on Inequality*** |
|---|---|---|---|---|---|
| ***Argentina*** | | | | | |
| Electricity | 3.8 | -16.1 | positive | positive | reduced |
| Telephone | 33.3 | -32.5 | positive | positive | reduced |
| Water | | -16 | | | |
| ***Bolivia*** | | | | | |
| Electricity | 2.9 | -8.3 | lgly positive | positive | reduced |
| Telephone | 21.6 | 26.2 | lgly positive | positive | increased |
| Water | 14.3 | | | | |
| La Paz, El Alto | | -10.5 | positive | positive | reduced |
| Cochabamba | | 43 | negative | positive | none |
| ***Mexico*** | | | | | |
| Telephone | 41.4 | 47.9 | n.a. | n.a. | n.a. |
| Water | 6.8 | 9.2 | n.a. | n.a. | n.a. |
| ***Nicaragua*** | | | | | |
| Electricity | 11.7 | 24.2 | mixed | lgly positive | sm. increase |

Adapted from McKenzie and Mookherjee, 2002.

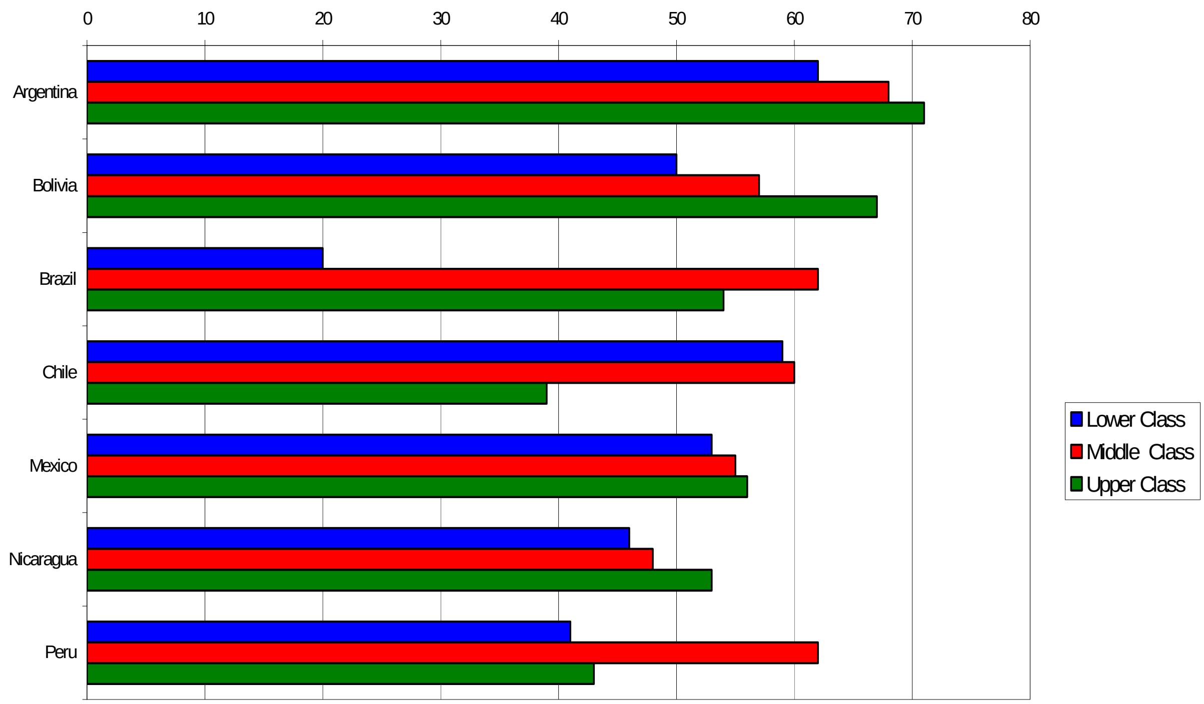
Welfare calculations are vulnerable to assumptions about elasticities and counterfactuals, but there is other evidence for benefits. In Mexico and Chile privatization and regulatory reform of state electricity, telecommunications and airlines improved total factor productivity and service quality, as well as consumer welfare, worker welfare and total welfare (Galal, et al. 1994). Similar outcomes are reported for urban water in Buenos Aires and Santiago (Shirley 2002). Studies of telecommunications reforms in large samples of developing countries find that privatization combined with competition increased access to services (Petrazzini and Clarke 1996, Ros 1999, Wallsten 2000). Ramamurti (1996) finds that privatization of the railroads in Argentina improved productivity and service, and reduced costs.

Negative perceptions could arise because reforms had adverse effects on the most vulnerable groups, but that is not the case. Some observers maintain that privatization and competition leads profit-oriented utilities to "cream skim" – serve the most profitable customers and ignore the less profitable poor who require new investment for them to access the service. The poor are usually the ones who did not have access before reform, and because of expanded access their welfare increased in all the cases in Table 1. Others suggest that even if access is expanded, cost recovery pricing makes the service unaffordable to the poor. This view is challenged by Clarke and Wallsten (2003) who analyze household expenditure surveys and find that consumption of services by the poor increased after reforms. For example, even though electricity prices went up after reform in Brazil, Colombia and Peru, access by all households and especially by poorer households increased, sometimes substantially. This fits with their evidence for water supply as well. Galiani et al. (2002) find that child mortality fell by five to nine percent in the Argentine provinces that privatized water, thanks to a reduction in infectious and parasitic diseases. These effects were largest in the poorest regions, where access and water quality were the lowest before reforms.

Yet even where the poor seem to benefit, surprisingly large numbers do not view privatization as beneficial (Graph 3). It's not surprising that most middle class consumers -- who probably already had service and now must pay more for it -- have negative opinions of privatization. More surprising is that lower class support for privatization is so small -- smallest in Argentina and Chile, the two countries that reformed the most.

The Buenos Aires water concession provides insights into how outcomes that seem almost Pareto optimal can still generate controversy (see Alcazar, et al. 2002). The

**Graph 3: Negative Views of Privatization by class in 2000***
**(% of class' respondents who disagree that privatization has been beneficial to the country)**




*Socioeconomic class is sefl-reported. Lower class less than 30 observations per country except for Mexico. Upper class less than 30 for Bolivia, Mexico, Peru.
Source: constructed from data from Latinobarometro in McKenzie and Mookherjee (2003).

concession contract signed with a French private operator in December 1992 led to a substantial increase in investment: as a result 1.5 million additional people had access to piped water and 583 thousand to sewerage by 1998. Unlike many other cases, water prices did not go up, they went down. Tariffs were reduced by almost 27 percent at signing and, despite subsequent increases, probably did not regain real 1992 levels for five years. Total domestic welfare in Buenos Aires increased by $1.7 billion compared to a counterfactual with no reforms, and 80 percent of this gain went to consumers (according to estimates in Alcázar, et al. 2002). Workers also gained since layoffs were done through voluntary early retirement and the workers who remained received 10% of the shares in the privatized water company.[4] Nevertheless positive opinions of the concession fell from 36 percent in 1993 to 18 percent in 1997, while negatives rose from 33 to 52 percent (Centro de Estudios Unión para la Nueva Mayoría cited in Frade and Sohail Khan 2003, p. 275).[5]

Sector reforms seem to be unpopular despite, rather than because of, the consequences. McKenzie and Mookergee (2003) give three reasons why sector reforms might be unpopular:

1. Inadequate public information about the benefits of reform, in part because benefits are widely diffuse and less visible while losses are highly concentrated and very visible, combined with humans' psychological tendency to dislike losses more than we value gains;
2. Association of privatization with other unpopular and perhaps painful pro-market reforms, such as fiscal contraction and trade liberalization;
3. Beliefs that basic services such as water or electricity "should not be subject to the profit calculus of multinational corporations" (McKenzie and Mookherjee 2003), combined with pessimism about the ability of the market, media and regulators to compel private enterprises to serve the public interest.

[4] There is also evidence that service improved. For example, response times to complaints were much quicker, less than a third of the time it took before privatization, and three years after the concession more than half of all consumers had adequate water pressure, compared to 17% before the privatization (Alcázar, et al. 2002).
[5] About 27 percent were neutral and 3 percent had no opinion.

Possibly all these factors contributed to the public's negative perception of sector reform to some extent. The first two are difficult to address. Inadequate information may seem like a tractable problem, but government public relations campaigns may not be trusted and government may not be able to overcome some kinds of information imperfections.[6] Diffuse benefits and concentrated losses are inherent in sector reform. Further, the earlier discussion suggests that reforms are unpopular even where there are few losses. The association of sector reform with other painful market reforms is often unavoidable: a macroeconomic crisis is usually necessary to motivate the change in the political status quo that is a prerequisite for sector reforms.

On the face of it the third reason for the unpopularity of reform seems remediable. More attention to political sustainability and to safeguarding the public interest in the design of sector reforms could reduce public suspicion of privatization and pro-market reform. Once again the Argentine water concession is instructive. While its unpopularity was partly due to some of the intractable reasons listed above, the design of the concession was also at fault. The provisions of the contract and the structure of the regulator fed customers' view that their interests were threatened and there was no politically independent body protecting them.

One design flaw was the tariff system. The concession did not change Buenos Aires' opaque and inefficient tariff regime based on a flat rate adjusted by five different factors (size of property, location of property, and size, type and age of dwelling and other constructions). This tariff system made it impossible for customers to decipher, contest, or control their bills. Tariff increases were mandated whenever a detailed and complex

[6] For example, poor unconnected users in Buenos Aires often relied on shallow wells and septic tanks or privies and suffered higher disease rates from bacterial contamination. These users may not have been aware that their water was contaminated.

cost index increased by more than 7 percent, resulting in lumpy, nontransparent and controversial rate hikes. Since the concession was awarded to the operator that bid the largest tariff reduction, the public tended to view any tariff increase as evidence that the original bargain was a bad deal for the country.

The politicized regulatory agency was a second problem. The agency's board was made up representatives of the federal, provincial and local governments. Contrary to the intent of its charter, board seats were treated as political appointments and directors changed whenever the political leaders changed. Political rivals controlled the different levels of government and the board was often paralyzed by partisan disputes. When directors did cooperate it was often to engage in politically motivated horse-trading and sometimes to make legally questionable but politically popular decisions that were subsequently overturned by the executive branch.

A third problem was the lack of regulatory independence. Decisions were not just reversed by the executive, which even overturned fines levied on the operator for failure to meet the terms of the contract; on several occasions the executive branch bypassed the regulator and reached agreement directly with the company.[7] Although executive intervention helped preserve the credibility of the contract, it also signaled consumers that there was no independent regulator to adequately safeguard their interests.

A final flaw was the decision to charge new users for the cost of extending the secondary network to serve them. Under state ownership all users had shared this cost. Although the company was required to help new customers finance the charge, the

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[7] Decisions could be appealed to the Supreme Court, but in Argentina the Supreme Court is not seen as neutral; since Peron it has been famously vulnerable to politically motivated interference by the executive (see Spiller and Tommasi 2000). Justices are regularly impeached and one of newly elected President Menem's first acts was to increase the number of Supreme Court judges from five to nine (Alcázar, et al. 2002, p. 83).

operator gave new consumers only two years to pay what was a large sum for low-income households.[8] This "infrastructure charge" roused resentment and most new customers refused to pay it. Eventually the contract was renegotiated and the charge eliminated and replaced with rate surcharges through a highly controversial negotiation that further fed public suspicion.

Judging from the Buenos Aires water concession, it may be possible to improve acceptance of sector reforms by designing them with greater sensitivity to political sustainability. Phasing in price increases gradually; awarding the concession on the basis of bids for new investment instead of price reductions; designing a transparent and efficient tariff regime and installing meters; spreading the cost of the expansion across all users or requiring better financing terms for poor customers; creating a less politicized, more independent regulator and a separate and more neutral appeals court; all these choices might have made the concession more politically sustainable. Of course some design flaws that seem evident with hindsight may not be obvious at the time of reform. More importantly, many key actors are not likely to be sensitive to political sustainability. The technicians and advisors who design reforms are focused on and skilled in economic and technical rationality not political sustainability. Foreign advisors and donors are unlikely to understand the demands and compromises required by local circumstances. Politicians may have too short a time horizon to care about long run acceptance or might believe with some justification that a reform with widespread benefits would eventually be popular regardless of its flaws. This suggests that the

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[8] The infrastructure charge was between $615 and $912 on top of the usual connection charge ($492-$616, all numbers are 1995 US dollars). The average monthly income in the poorer areas was $200-$245 a month. See Alcazar (2002, p. 85).

reform team needs to include both analysts and former political actors with a deep understanding of the local political economy.

Design flaws notwithstanding, it is still a puzzle why consumers so dislike a reform that provides most with benefits and few with losses. Most political economy models assume that reforms with large positive payoffs, with many winners and few losers, will eventually become popular. Fernandez and Rodrik (Fernandez and Rodrik 1991) show how uncertainty over the distribution of gains and losses can prevent reforms with positive payoffs from being implemented, but too they assume that such reforms would become popular if they were ever implemented. The three reasons given by McKenzie and Mookergee (2003) seem inadequate to explain the large and growing unpopularity of the Buenos Aires water concession.

The dislike of the Buenos Aires concession and of sector reforms in Latin America more broadly may stem from deeply rooted and widely generalized distrust of market forces and government safeguards. What lies at the heart of this distrust may be partly ideology stoked by populist politicians and interest groups. But it is also partly a response to reality: even when consumers gain, much bigger gains often accrue to politicians and their cronies. My hypothesis is that the source of this distrust is not the gain but the game. There is wide acceptance of differential gains in market economies when people feel the gain is somehow proportionate or "deserved," especially when they believe that they might also have opportunities for profit. My premise is that many Latin Americans see sector reform as an ultimatum game.[9]

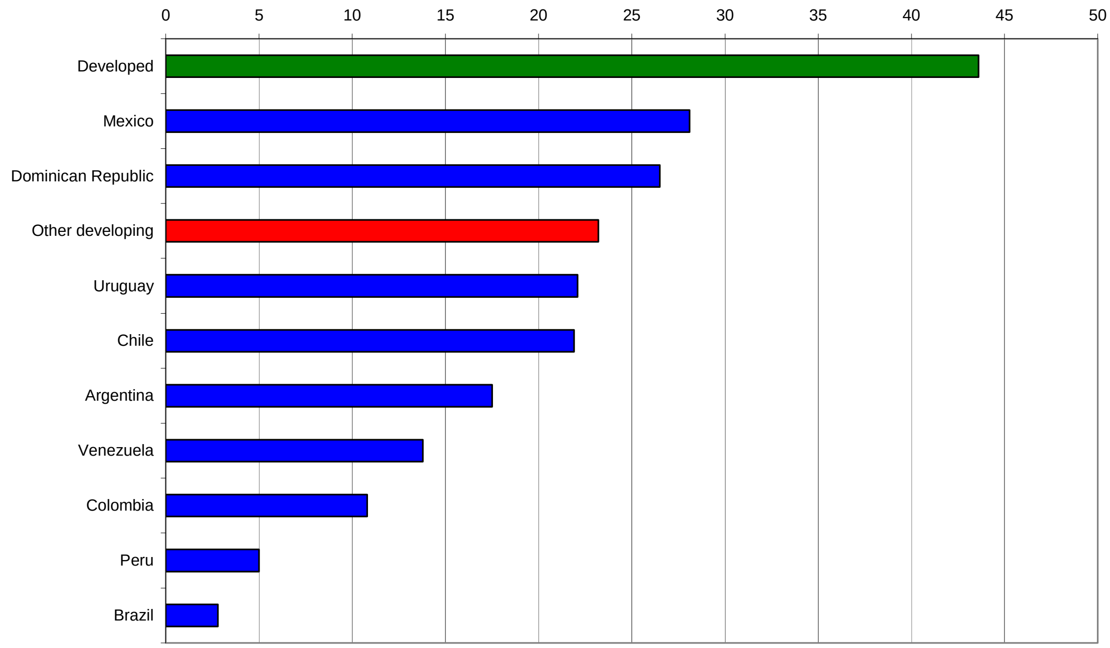
In the ultimatum game two strangers are given a sum, say $100, to split. Player A, the Proposer, can offer any share she wishes, from 0 to $100, to player B, the Decider.

[9] See Guth et al. (1982), Thaler (1988) and Camerer and Thaler (1995)

If B accepts A’s offer, both players keep their shares of the money; if B rejects A’s offer, neither player receives anything. According to rationality assumptions, B should accept any positive offer, however small, and A should offer as little as possible. B had nothing before and it is rational – by this reasoning – to prefer something to nothing. But when the game is actually played the Deciders regularly reject offers they consider “unfair.” Bs turn down surprisingly large offers and the game converges at about $40 for B and $60 for A. Although variants of the game produce different proposals, the preference of the Deciders for an “equitable” division of the pie and their willingness to forgo a share in order to punish Proposers for “unfair” offers persists.

It is beyond the scope of this essay to test this premise. Nonetheless, there is evidence of a broad sense of mistrust in the region, higher than in other developing areas, a mistrust that is not a product of sector reform, but precedes and surrounds it. Data on trust from the World Values surveys suggest that Latin Americans have much higher levels of generalized mistrust than in other developing countries (Graph 4). Less than a third of Latin Americans surveyed in 2002 believed that you could trust the people who run the government of their country to do what’s right and on average believed that 71 percent of civil servants were corrupt (Latinobarómetro various).

**Graph 4: Trust in Latin America, Other Developing Countries, & Developed Countries**
**% who responded most people can be trusted, 1995-96**




Source: World Values Series

If sector reform -- and market reform more broadly – are indeed perceived as an ultimatum game, then their unpopularity has deep institutional roots in laws and norms of behavior that give politicians and their business cronies access to large windfalls and curtail less privileged groups' opportunities for advancement or redress. For sector reform to have a future in Latin America it is therefore not enough for reforms to benefit consumers, and to safeguard their interests through better regulation and contractual design, this deeper sense of injustice would also need to be addressed. Unfortunately we have limited understanding of how to change the embedded institutions that foster corruption, reduce economic opportunities and deny legal protection for many citizens (Shirley 2003). There is evidence that the underlying institutions responsible for Latin America's unequal political and economic rights are deeply rooting in the colonial and even pre-colonial past (Engerman and Sokoloff 2002). Despite the promises of some in the foreign aid community, there is little evidence that outsiders can change these embedded institutions short of occupying the country.

Opportunities for change do arise, however, and at those moments the design of more sustainable reforms will depend on an understanding of formal rules and informal norms, and the history, failings and incentives of these local institutions. Local scholars have a comparative advantage in understanding the idiosyncrasies of their country's institutions and in devising sustainable reforms, but they are often isolated and under-funded and tend to leave the country or move away from research. This problem can be addressed, but only slowly: wholesale schemes to build local knowledge rapidly fall victim to the same institutional failings that undermine other well-meaning reforms.

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