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Privatizations and *social welfare*

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Privatization is an important dimension of the adjustment process in Latin America. The process is well advanced in a considerable number of countries, and there are few nations which have not embarked on a privatization programme, with special emphasis on the sale of public enterprises. This article analyzes the many factors propelling the privatization process in the countries of the region and examines a socioeconomic dimension of the process which has not hitherto received much attention: i.e., social equity. In this respect, it identifies shortcomings in the privatization process and suggests concrete ways of increasing its net social benefits. The article highlights five aspects which are of fundamental importance for achieving greater equity in such processes: transparency; systematic efforts to secure the highest possible price for the enterprises sold; integral compensation for employees obliged to leave the enterprises; assignment of the income received from privatization to a special social development fund, and more effective public regulation of privatized enterprises that may be able to exercise market power. The objective of social equity must, of course, be reconciled with the other objectives identified in the article as being germane to the decision to privatize. Nevertheless, reconciliation with many of the other express objectives of privatization will not necessarily demand any major sacrifices of equity, since many complementary factors also enter into play.

I

Introduction

The crisis of 1982 –the worst in the region since the 1930s– detonated a process of radical economic policy change throughout Latin America. It also proved to be relatively unresponsive to traditional conjunctural stabilization and adjustment policies.¹ Moreover, its magnitude and protracted nature dealt a fatal blow to the dominant economic strategy in the region, which had been typically characterized by an emphasis on inward-looking import substitution and ample direct State intervention.² What emerged to take its place, gradually at first, but with ever greater intensity as the decade proceeded, was a new paradigm inspired by the traditional liberal market principles that were especially fashionable in some industrialized countries during the 1980s. Thus, the policy focus of most Latin American countries broadened so that adjustment and stabilization efforts included major neoconservative-oriented structural changes focusing on internal and external liberalization and deregulation and the promotion of a subsidiary role for the State in the domestic economy. One of the cornerstones of the new approach (baptised the Washington Consensus) is the privatization of public enterprises.³

This paper provides an overview of the privatization processes pursued in the region, and focuses on some socioeconomic dimensions of the process which have not been given much attention to date. The first section discusses the magnitude of the privatization processes in Latin America. In the next section, an analysis is made of some of the apparent motives behind the countries' decision to privatize. The third section focuses on one objective which has sometimes been too easily traded off in privatization processes –social equity– and suggests ways in which the net social benefits of the process could be enhanced. The last section presents some conclusions.

The subject of privatization in developing countries raises a vast number of potential issues which become still more complex when examined in the fast-moving context of individual countries. For this reason the overview is relatively general in its focus and selective in its content. It also should be mentioned that the comments made concentrate on divestiture, which so far has been the most prevalent privatization technique in the region.

II

The magnitude of privatization processes

Public enterprises (PEs) have typically had a high profile in the economic activity of the region. Ironically, however, consistent and comprehensive data on the region's PEs are hard to come by. Their importance can nevertheless be illustrated by reference to a

few countries. For instance, just before the crisis the value added by PEs as a percentage of GDP was about 5% in Brazil, 14% in Chile, 8% in Mexico and 30% in Venezuela. Likewise, the region's PEs were major investors in fixed capital, with their activity in this area often equivalent to a quarter or more of total gross investment (table 1). Each country's story as regards the origin of its PEs is different, but in practically all cases there is a combination of factors related, among other things, to the deliberate promotion

¹ Apart from the sheer magnitude of the crisis and the fragility of the new democratic political regimes, the slow response was also undoubtedly related to the very serious shortcomings in the construction of multilateral conditionality and the official management of the debt problem, which tended to underfinance the adjustment process. See Devlin (1989), Ramos (1992), Killick *et al.* (1984) and Ground (1984).

² But the financial crisis was also a setback for the monetary approach to the balance of payments and for proponents of "self-regulated" credit markets. See Ramos (1986), French-Davis (1982) and Devlin (1989).

³ There is a whole range of privatization techniques, of which divestiture –total or partial transfer of State-owned enterprises to the private sector– is only one. For a discussion of this, see ECLAC (1992b).

TABLE 1

**Latin America: selected indicators of the
participation of public enterprises before the 1982 crisis**

	Value added as % GDP	Fixed investment as % of gross investment (1980)	Participation in domestic credit (1978)	Employment (% of total) (1980)
Argentina	4.6 ^a	15.4	...	3.1
Brazil	4.7 ^b	25.8 ^c	11.2	3.0 ^d
Chile	14.2 ^e	15.8	...	20.4 ^e
Colombia	2.6 ^a	12.7	...	...
Costa Rica	...	23.2	12.8	...
Ecuador	...	21.1	...	...
Guatemala	1.1 ^a	13.3 ^f	...	...
Honduras	...	14.6 ^g	...	...
Mexico	8.2 ^e	23.1	18.9	...
Paraguay	3.1 ^a	6.5 ^f	...	...
Peru	...	10.4	26.4	...
Uruguay	...	18.3 ^f	...	...
Venezuela	30.9 ^e	35.7	1.6	...

Source: Nair and Felippides (1988); Floyd, Gray and Short (1984).

^a1978-80 (factor cost).

^b1982 (market prices).

^c1981.

^d1982.

^e1980 (market prices).

^f1978-80.

^g1978-1979.

of investment and development, nationalization measures deriving from unexpected political or financial events, the support of macroeconomic stabilization objectives, and employment and distributional considerations.⁴

Data for a considerable number of the countries in the region indicate that just before the crisis the overall financial performance of the region's PEs was almost uniformly associated with heavy financing requirements (table 2). The picture improves markedly for a few countries when the PEs' balances are adjusted for transfers between the firms and central government. Nevertheless, it is noteworthy that even after that adjustment important pre-crisis financing requirements were registered for the PEs of Argentina, Brazil, Colombia, Costa Rica, Ecuador (non-oil) and Mexico (non-oil).

During the crisis years PEs confronted a very complex operational environment as central governments tried to stabilize domestic prices and reduce the public sector's financing requirements. The serious fiscal problems induced adjustments in the region's PEs and a reduction of their demands for financing:

between 1981-1982 and 1986-1987 the countries with initial deficits either lowered their negative balances or converted them into surpluses and, with the exception of Venezuela, those with initial surpluses increased their positive balances. Excluding Venezuela and the oil-producing PEs of Mexico and Ecuador, the total improvement in the PE balances of the countries listed in table 2 was equivalent to 2% of GDP. It should be noted, however, that while significant, the improved financial balance nevertheless had an artificial component because it included the effects of sharp and unsustainable cutbacks in investment activity. This is seen in column DH of table 2, which calculates financial balances on the basis of pre-crisis investment levels.

Expenditure cutbacks and adjustments in scales of charges were initially the most important instruments for reforming the financial performance of PEs. However, sooner or later almost all of the countries in the region began to opt for more drastic reforms involving outright divestiture or liquidation of their PEs.⁵ The scope of most of these privatization programmes has been extremely ambitious, including in

⁴ For an excellent history of public enterprises in Chile see Ortega (1989).

⁵ From here on, the term "PEs" will be used broadly to include public entities that are not necessarily formally classified as enterprises.

TABLE 2

Latin America: savings and deficits of public enterprises, 1980-1981 and 1986-1987^a
(Percentages of GDP)

Country	D 1980-1981 (1)	D 1986-1987 (2)	D* 1980-1981 (3)	D* 1986-1987 (4)	DH (5)	Absolute variation in D* (6)=(4)-(3)
Argentina	-3.39	0.59	-4.92	-2.75	-3.21	2.17
Bolivia	0.10	-2.90	3.65	7.95	7.70	4.30
Brazil	-1.69	0.10	-3.10	-2.10	-4.22	1.00
Chile ^b	-1.33	0.78	5.47	10.33	11.93	4.86
Colombia	-2.00	-1.41	-3.16	0.08	-0.21	3.24
Costa Rica	-2.37	0.97	-1.55	3.46	4.11	5.01
Ecuador	-0.63	-1.77	4.60	4.09	4.46	-0.51
(Non-oil-exporters)	(-1.60)	(-0.55)	(-1.92)	(-0.67)	(-1.44)	(1.25)
Mexico	-1.30	0.25	1.49	4.62	3.53	3.13
(Non-oil-exporters)	(-1.57)	(-0.26)	(-6.22)	(-4.97)	(-5.77)	(1.25)
Uruguay	0.26	0.10	2.69	3.14	3.00	0.45
Venezuela	-2.33	-2.62	11.08	5.16	-0.05	-5.92
Total^c	-1.48	-0.74	1.20	2.63	1.68	1.43
Subtotal^d	-1.14	-0.32	-0.80	1.22	0.90	2.02

Source: ECLAC, Economic Development Division.

^a The symbols used in this table are the following:

D = Total income less total expenditure.

D* = D - T (T = net transfers to central government, as registered in its accounts).

DH = D* plus difference in net capital account between 1980-1981 and 1986-1987.

^b For the period 1986-1987, the values used were those for 1985, which is the last year for which figures are available.

^c Simple average, excluding Chile.

^d Simple average, excluding Chile, Venezuela and the petroleum enterprises of Ecuador and Mexico.

almost all the cases major public services. The countries with the greatest experience in this respect are Chile and Mexico, followed by Argentina, Venezuela and Brazil.

Chile was the region's pioneer in privatization. In the period 1975-1982 the military government "reprivatized" more than 200 firms (mostly in the tradeable goods and finance sectors, and worth more than US\$1.2 billion in total) which had been nationalized or operationally taken over in the special circumstances of the controversial policies of the previous democratic government. Many of these reprivatized firms fell back into the government's hands in 1982-1983 as a consequence of a gigantic systemic collapse of the Chilean economy (Ffrench-Davis, 1982), but they were quickly transferred back to the private sector in 1984-1985 (Sáez, 1991; Hachette and Lüders, 1992). Soon afterwards, in 1985, the military government announced the beginning of the privatization of many of the country's large traditional PEs, which had hitherto been considered untouchable. Between 1985 and 1989 thirty public enterprises –producing both tradeable goods and major public services– were

divested in whole or in part, generating income equivalent to US\$1.3 billion (tables 3 and 4). At its peak in 1987-1988 the income from privatization operations was equivalent, on average, to 2% of GDP and 7% of current revenues of the consolidated public sector. At the end of 1989 there were 45 public enterprises in the country, compared to more than 200 in 1974 and 75 in 1970 (Sáez, 1991). These remaining PEs included the giant copper firm CODELCO, petroleum refining, and water and sanitation facilities.

In 1990, Chile's new democratic government slowed the pace and altered the content of the privatization programme: control of only a limited number of small public firms would be sold to the private sector, while a few other PEs would sell minority share packages. The government also planned to allow private participation in new public infrastructure projects, especially those sponsored by the public water and sewerage companies. In 1991 a small State shipping firm was sold and a minority share package in the Iquique free trade zone was offered on the local stock market.

TABLE 3

Latin America: value of privatization operations in six countries,^a 1983-1991

Year	Amount ^b	GDP ^c (%)	Fiscal income ^d (%)
<i>Mexico</i>			
1983	40	-	-
1984	5	-	-
1985	115	0.1 ^e	0.4
1986	100	0.1	0.4
1987	170	0.1	0.4
1988	520	0.3	1.2
1989	730	0.4	1.6
1990	3 205	1.3	5.2
1991	10 550	3.8	12.7
<i>Chile</i>			
1983	...	...	...
1984	...	...	...
1985	10	0.1	0.3
1986	230	1.4	4.0
1987	310	1.7	5.6
1988	560	2.5	8.1
1989	235	0.9	3.0
1990	...	...	...
1991	...	...	...
<i>Argentina</i>			
1983-1989 (no privatization operations were effected)			
1990	2 105 ^f	3.4	19.2
1991	2 901 ^f	4.5	21.2
<i>Brazil</i>			
1983-1990 (no privatization operations were effected)			
1991	1 700 ^g	0.4	1.6
<i>Venezuela</i>			
1983-1990 (no privatization operations were effected)			
1991	2 300	4.5	15.0
<i>Colombia</i>			
1983-1988 (no privatization operations were effected)			
1989	50	-	-
1990	75	-	-
1991	690	0.2	...

Source: Calculated on the basis of data from Gerchunoff and Castro (1992); Hachette and Lüders (1992); Ruprah (1992a); National Economic and Social Development Bank (BNDES), Brazil; Fondo de Inversiones de Venezuela; and ECLAC, Economic Development Division.

^a Refers to value of sales and not necessarily to cash flow.

^b Millions of dollars.

^c Equivalent in dollars.

^d Current income of the non-financial public sector.

^e Equivalent in pesos.

^f Includes foreign public debt paper valued at secondary market rates. Also includes original terms for the sale of Aerolineas Argentinas, which were modified in 1992.

^g Payment was almost exclusively in domestic debt paper.

TABLE 4

**Latin America: sectoral distribution of privatization, on the
basis of divestiture operations, 1989-1991**
(Percentages)

Sectors	Argentina	Mexico	Brazil	Venezuela	Chile	Colombia
Agriculture	-	2	-	-	...	-
Air transportation	14	3	3	6	...	-
Banking	-	52	-	5	...	3
Electricity	-	-	-	-	...	-
Manufacturing	2	10	95	-	...	72
Mining	27	-	-	-	...	-
Surface transport	5	-	2	2	...	25
Telecommunications	53	33	-	87	...	-
Others	-	-	-	-	...	-
Total	100	100	100	100	...	100

Source: *Latin Finance* (1991 and 1992) and ECLAC, Economic Development Division.

Mexico followed Chile in the pioneering of privatization in the region. The De la Madrid government initiated the process in 1983 and it was intensified in 1989 by the new Salinas de Gortari administration. The reform policy caused the number of public firms to decline from 1155 in 1982 to 280 in 1990 (Secretaría de Hacienda y Crédito Público, n.d.). About a third of this reduction was due to outright sale and the rest to liquidations, mergers and transfers to local authorities (Ruprah, 1992a; Tandon, 1992). The process initially focused on relatively small tradeable goods firms, but the size of the firms increased with time (Aeroméxico; Mexicana de Aviación) and the programme eventually included major public services, of which TELMEX is the most important. Road networks and commercial banks are also subject to privatization.

The total value of sales of PEs over the period 1983-1991 was more than US\$15 billion, 90% of this being concentrated in 1990-1991 (table 3). This concentration reflects the large size of the firms privatized in this period and the greater importance of outright sales relative to earlier years: the value of the sales in this latter period was huge, averaging the equivalent of 2.5% of GDP and 9% of current fiscal revenue. Unless the petroleum and electricity sectors become subject to privatization (the Constitution currently deems them to be strategic), it would appear that the Mexican process of divestiture could soon wind down.

Argentina began its programme in late 1989 under the new Menem government. In 1990-1991 seventeen publicly-owned firms involved in the

production of tradeable goods, including oil, and major public services were wholly or partially privatized; moreover, the most heavily trafficked highways were transformed into private concessions with rights to charge tolls. The value of sales of PEs in the period reached US\$5 billion, equivalent on average to 4% of GDP and 20% of current fiscal revenue (table 3).⁶ The Argentine scheme is probably one of the most ambitious in all Latin America, since the government plans to privatize all its remaining PEs and many public services during 1992-1993.

Brazil began to privatize under the Collor de Mello administration in October 1991. Four firms were sold during that year for a value of US\$1.7 billion, equivalent to about 0.4% of GDP and 1.6% of current fiscal income.⁷ The government initially identified 55 firms for privatization, all of them engaged in the production of tradeable goods. It is expected that the new government of Itamar Franco will introduce some modifications in the programme.⁸

⁶ About US\$1.1 billion of the total amount represents the market value of foreign debt paper which was used as a means of payment in several transactions.

⁷ Almost all the sales were paid for in the form of domestic debt instruments.

⁸ It is already known that the new government plans to modify some aspects of the privatization programme, in particular by drastically lowering the amount of debt paper that can be used as a means of payment.

Venezuela has about 370 State entities in a very wide array of sectors (Fondo de Inversiones de Venezuela, 1992); moreover, some of the firms are mixed capital ventures with foreigners. The government began a privatization process in late 1990 with a small bank. Then 7 firms producing tradeable goods and major public services were sold in 1991. The sales produced US\$2.3 billion, equivalent to more than 4% of GDP and 15% of fiscal revenue. Twenty-nine more firms in tradeable goods sectors and tourism services were scheduled to be sold in 1992. The original list, however, is rapidly expanding as 43

additional firms are being prepared for privatization, including the Caracas water supply company (Fondo de Inversiones de Venezuela, 1992). Nevertheless, the pace of the country's privatizations stagnated in the second half of 1992, due to events reflecting serious political instability.

Most other countries in the region are much less advanced in the privatization process than those mentioned above. However, by 1992 virtually every government in the region, except Cuba, had announced a major privatization programme and most had at least begun some minor sales of public firms.

III

Why are the countries privatizing?

In the theoretical framework of Jones, Tandon and Vogelsang (1990), a country should privatize public enterprises if this will bring about a positive net change in social welfare. This occurs when the social value of the privatized firm, plus the net social value of the public sector's receipts from its sale, is greater than the social value of the firm under public ownership.⁹

Of course few governments have had the time or inclination to make a complicated cost-benefit analysis in every case: they have typically relied on a more general and intuitive approach. Nevertheless, even in a more informal framework the number of factors potentially supporting privatization are often perceived to be so large that it is not surprising that so many governments have decided to initiate privatization programmes without more ado. Indeed, the scope of privatizations is becoming so massive that most governments seem in practice to be mimicking the strategy of Mexico's Salinas government: with respect to individual PEs the Mexican authorities changed the initial ministerial question from the De la Madrid administration's "Should we privatize?" to

"Why shouldn't we privatize?". This reformulated question has been behind the accelerated pace of privatization measures in that country (Ruprah, 1992a).

Below, I shall try to outline some of the major factors that seem to be explicitly or implicitly propelling the privatization processes in the region. The list is by no means exhaustive, but rather reflects those factors, or arguments, which I perceive to be of broad influence in the decision to privatize. The weights for each one, of course, differ among the countries.

It is also important to note that the analysis does not include detailed evaluation of the validity of the arguments involved. Such a task is beyond the scope of this article, in view of the very specific nature of many aspects of privatization, the difficulty of isolating many of the relevant causal factors, the as yet limited experience of the privatized enterprises, and the almost metaeconomic nature of some of the most enthusiastic arguments put forward in favour of divestiture.

1. Structural factors

a) Ideology

As mentioned above, there has been an ideological shift in the region that lays stress on private sector initiative. The central idea is the "subsidiary State", i.e., in the commercial sphere the public sector should be limited to essential activities that the private sector cannot or will not perform. The new focus has won growing theoretical support (summarized nicely by

⁹ In other words, the government should sell the firm if $V_{sp} + (\alpha_g - \alpha_p)Z > V_{sg}$, where V_{sp} is the social value of the firm under private ownership; V_{sg} is the social value of the firm under public ownership; Z is the sale price, and α_g and α_p are the shadow prices of the public and private sector income, respectively. Naturally, the social value of the firm under public or private ownership will be assessed in the light of a wide range of indicators of the net benefits for society. See Jones, Tandon and Vogelsang (1990).

Killick, 1989) and has been further encouraged by the political success of England's ambitious privatization programme during the Thatcher government. The interpretation can be subtle and selective, but it can also be more emphatic and quantitative, picturing government failure as nearly always worse than private market failure: hence the advocacy of drastic reduction of the size of the State in absolute terms, irrespective of the theoretical merits of public intervention. The benefits of the new strategy purport to be greater efficiency through the freeing-up of market forces and greater equity and social participation through the democratization of capital (Hanke, 1987).

The new ideology can be observed in virtually all the governments of the region, though it has not always been a first, or even second, order consideration in the decision to privatize. It was, however, clearly the main motivation of the Chilean privatization process of 1985-1989 (Hachette and Lüders, 1992), carried out as part of a programme proposed by the military government's ideologically hard-line "Chicago boys". Mexico's programme also had ideology as a first-order consideration. In that country, the emergence of a new young generation of U.S.-educated government bureaucrats, less emotionally linked to the Statist tradition that followed the Mexican Revolution, brought with it the perception that the State-dominated economy needed fundamental rebalancing (Ruprah, 1992a). The tone of Mexico's reform has been subtle and selective, however, with the government emphasizing that the State would redeploy its efforts to the social sector (Khanna, 1992).

b) Internal efficiency

Experience in the region suggests that the public sector often has difficulty playing the dual role of principal and agent. It is generally accepted that the principal-agent problem can be more difficult when ownership is dispersed, due to the limited access to information and the free-rider problem. Hirschman (1970) argued that the principal has two options in this respect: to defend his interests ("voice") or to retreat ("exit"); moreover, in the situation in question the exercise of "voice" to demand greater efficiency involves high costs, while a large part of the potential benefits of effective "voice" are bestowed on third parties. It is because of this that "exit" is often the preferred response; indeed, it reflects an old Wall Street dictum: "If you don't like the management, then sell your stock".

This traditional problem of the relationship between principals and agents could be considered potentially much more serious for a public enterprise, because in this case the dispersion of ownership is extreme: the public sector is permeated by society at large. In this environment the principal's potential objectives cover the entire spectrum of interests that can be effectively voiced by that society. However, as the use of voice and the monitoring of performance have high costs, voice will likely be exercised only by those groups which perceive enough benefits to pay the costs that are needed for that effective voice. Since the benefits of greater efficiency in a public firm are dispersed very widely throughout society, the exercise of voice for this objective can be neutralized by the stronger voices of groups with objectives that will bring them more tangible and concentrated benefits.

This intensified principal-agent problem of public firms is by no means an insurmountable obstacle, however, as is demonstrated by a number of countries with a tradition of efficient public enterprise management. Indeed, there is evidence that what really matters for efficient firm management is market structure rather than ownership *per se* (Vickers and Yarrow, 1988). Nevertheless, it could be plausibly argued that, other things being equal, the social cost (effort) of exercising voice on behalf of efficiency is relatively less for the principals of a privatized firm than for those of a public enterprise.

Exit (privatization) and the reallocation, or reduction, of the State's net worth could therefore be proposed as an attractive and less costly option for the achievement of greater efficiency. In effect, the privatization of PEs creates substantially more concentrated ownership, which in turn narrows the principal's potential objectives and enhances his power to monitor the performance of management and labour. In sum, it is assumed that the voice of profit maximization will face fewer competing voices (and hence lower monitoring costs) when the firm is in private hands.

Where monopoly power is involved, efficiency in the allocation of resources will require some type of public regulation of the privatized firm. However, since public monitoring must now take place "outside" the firm itself, there will be a rise in the public cost of gathering the relevant information needed for effective regulation. Nevertheless, a decision to privatize must mean that the new public costs of external

regulation are perceived to be less than the sum of the public costs that must be assumed if the State is to effectively play the triple role of principal, agent and public regulator of an enterprise. At least theoretically, privatization creates a more transparent division of labour, which makes for potentially better accountability: to put this simply, the private principals and agents must only pursue some mode of profit maximization, while public regulators must only pursue efficiency in resource allocation. Meanwhile, the State can reallocate its receipts from privatization to other activities with returns that are socially high, but privately too low to attract private capital, or else the receipts can be allocated to the reduction of public debt. Roughly speaking, in either case the government's net worth remains constant (assuming no undervaluation of the firm sold). Alternatively, the State can retreat and reduce its net worth, by using the privatization receipts to finance current public outlays.

All of the governments of the region have appealed to efficiency to justify the privatization of their firms. It is generally accepted that most PEs have traditionally confronted a proliferation of conflicting public objectives, such as investment, acting as conduits for foreign savings, charging low prices to aid the poor or to support stabilization efforts, creating demand for the products of domestic capital goods industries, regional development strategies, distributing political largesse of different types, etc. Some of these objectives were consistent with development, while others were not, but clearly the institutional arrangement was often inefficient, as a single instrument (the PE) was invariably used to accomplish multiple, and often conflicting, social objectives.

In practice, efficiency criteria seem to have been an especially important motivating factor in countries like Argentina, Peru and Venezuela, which have had notoriously inefficient PEs and government apparatus that has been judged too weak to effect the reforms needed to raise the voice of efficiency. In other words, authorities have seen "exit" (in the form of privatization) as the only viable option for overcoming the principal/agent problem. On the other hand, the efficiency factor may have been less of a driving force in a few countries with strong government apparatus and the potential ability to reform PEs, or those where the PEs' performance was already at least acceptable in general terms. The best example is Chile, where the military government had the power

and demonstrated capacity to reform enterprises: aided by an extremely authoritarian setting, the authorities effectively created greater concentration of ownership in PEs—thus lowering the costs and raising the benefits of exercising the voice of efficiency—even though the principal remained nominally public. As a consequence, Chilean PEs were generally relatively efficient and financially viable well before the decision to privatize them.¹⁰

c) Changes in sectors considered to be "strategic"

Since the decision of almost all the countries in the region to dramatically and rapidly liberalize trade (ECLAC, 1992a), governments have assumed that deregulated markets are now contestable and that foreign competition will cause the number of domestic monopolies and oligopolies in the tradeable goods sectors to decline markedly. In effect, regulation of rents by market forces in principle reduces the need for direct regulation via public ownership.

Many authorities are of the opinion that changing technology and innovative administrative techniques have eroded, or at least called into question, the presence of natural monopolies in many public services. Indeed, some technical support has emerged in favour of: i) depackaging certain major domestic public services, as has occurred in the Chilean and Argentine electricity sectors; ii) dividing former monopolies into duopolies, as in the case of the Argentine telephone system (this makes possible, at least in principle, external public regulation via "yardstick competition" between the two firms);¹¹ and iii) building and managing public infrastructure through regulated private concessions, as in the case of the Argentine and Mexican road networks. These technical developments, coupled with deregulation and the formation of contestable markets, have reduced the perceived need for PEs.

¹⁰ Moreover, many of the remaining instances of inefficiency were imposed by the military government's ideological preferences, which induced explicitly restrictive policies on the expansion of PE activity. For instance, the public telephone company was not allowed to diversify into new services; new investment was limited; profits were siphoned off to the central government budget, and the capacity to borrow was very restricted. This firm was also seriously hurt by the 1982/1983 economic collapse, induced in part by the government's macroeconomic policy (Castillo, 1991).

¹¹ For a discussion of yardstick competition, see Vickers and Yarrow (1988).

Monopolistic and oligopolistic control of internationally tradeable goods (including technologies), as well as the dominant position of the U.S. economy, has been sharply reduced by the great expansion of the world economy since the war. In effect, Latin American countries objectively face a more competitive world economy and a more complex geopolitical matrix than they did in the inter-war period and in the 1950s and 1960s. The active participation of European firms, including those from Spain, in the privatization processes of Argentina, Chile, Mexico and Venezuela,¹² as well as that of privatized Chilean companies in the divestiture processes of Argentina and Peru, bear witness to the dispersion of international economic power. In these circumstances it could be argued that there is less need for a strong countervailing force in the form of State ownership of productive enterprises.

d) Repositioned private sectors

One of the factors giving rise to the public entrepreneur was the immaturity of domestic private sectors and markets. After the considerable post-war growth and integration of Latin America with world economies and cultures, there is now a feeling in the region that the domestic private sectors have matured to the point where they are capable of successfully operating in many sectors formerly dominated by PEs.

Recent developments in the world economy have also strengthened the apparent attractiveness of transferring property to the private sector. The State's debt crisis, plus its forced absorption of private sector debts,¹³ have combined to help make the latter a superior player in world capital markets. There is also some perception that more competitive world markets have also shifted advantage to the private sector because of its capacity for quickly accessing and adapting changing technology and forming alliances with foreign partners. These developments have caused governments to seek opportunities for realigning their public investment portfolios.

e) The perceived need to project consistency

In the context of a transition to a model which gives priority to private capital, an important State presence—even an efficient one—in economic sectors that are attractive to local entrepreneurs can create a degree of conflict and uncertainty which may ultimately lead to a decision to privatize. For instance, when the State maintains a commercial presence in a sector that has been largely privatized, it could be a disincentive for private investment there, because of the private firms' fear that they will not be able to effectively compete with the State entity, which potentially can receive favours from public policies. On the other hand, the value of the public sector's patrimony in the sector can also effectively deteriorate if the government withholds new investments in order to avoid being accused of squeezing out private initiative. In these circumstances political pressures can eventually develop to a point where even potentially useful State firms are sacrificed in order to preserve or promote the new consensus about the division of labour between the public and private sectors.¹⁴

2. Conjunctural factors

a) Political credibility

Governments have often used privatization measures as a signal of their commitment to the new ideological model, thereby attempting to improve the expectations of domestic and international economic agents. While this motive is widespread in the region, it has been especially important for newly-elected governments which have become committed (by conviction or circumstances) to a neoconservative economic strategy, but which have initially lacked the ideological credentials of the Washington Consensus and/or have encountered difficulties in pushing forward reforms on other fronts.

Credibility was a factor of prime importance in the emergence of Argentina's first round of privatizations in 1989/1990. Assuming power in the middle of an economic crisis, the government's surprise announcement of the privatization of ENTEL and

¹² Ironically, some of the European firms like Telefónica, Iberia and France Telecom are public enterprises.

¹³ During the external debt renegotiations creditors frequently required the public sector to absorb the private sector's debts with foreign banks. This was a highly arbitrary policy with no real economic justification (Devlin, 1989).

¹⁴ This problem seems to be emerging in Chile, especially in the electric power sector, where private and public firms compete in a sometimes conflictive setting. There has been a dispute between a State power generation firm and privatized power generation companies over investment in a thermal plant in Northern Chile.

Aerolíneas Argentinas was motivated in part by the need to transform a formerly populist image and stabilize the expectations of the economic agents.¹⁵ Credibility also seems to have been a first-order consideration in the Collor de Mello government's decision to privatize in Brazil; in effect, it did indeed produce some concrete forward movement in a troubled economic setting that had not been receptive to across-the-board reforms. Credibility also appears to have had a lot of weight in the privatization operations of the newly-elected governments in Venezuela and Peru, which also assumed power in the midst of severe economic crises. In the first-named government, it was part of a programme that erased an initially populist image, and in the latter it helped to give definition to a new political party that had lacked a clear image when it assumed power.

b) *Fiscal crisis and stabilization*

The sale of State assets can temporarily close macroeconomically destabilizing fiscal gaps. The sale itself creates an immediate financial transfer to the government, while it also affects future fiscal flows. If a firm was losing money, an annual negative fiscal transfer could be converted into positive flow of tax revenue, assuming private ownership is profitable. If the public firm was already profitable, the net future flow depends on the tradeoff between taxes and dividends of the public firm and taxes paid by the privatized firm.

The privatization option becomes tempting when possibilities for reducing fiscal expenditure have been exhausted; when the government is unable or unwilling to raise revenue through increased tax collection, or when non-inflationary sources of public finance have become exhausted. In these circumstances there is the option of capitalizing the potential future receipts of a public enterprise through its privatization. This might be termed a "Pan Am" effect, as financial distress induces the sale of potentially profitable assets to finance expenditures which cannot be compressed without threatening the short-term viability of the entity in question.

A fiscal deficit which generates serious inflation and balance of payments problems is obviously a socially costly phenomenon: the situation can inhibit reforms, bring unwanted conditionality from the IMF,

paralyze investment and growth, and have regressive distributional effects. Hence, every peso of additional revenue today, employed to close the fiscal gap, could have a very high social rate of return. Moreover, in a situation of severe macroeconomic disequilibria and recession, a peso of fiscal revenue will usually have a higher shadow price than a peso of private consumption or investment.

In these circumstances, an increase in tax collection could be an attractive option, especially if the taxes involved are not regressive in character. However, in an open, highly deregulated economy with an economic recession and a weak political and institutional setting, greater tax collection—especially of a progressive type—could be very difficult to effect. Indeed, in today's fragile political settings, an increased tax burden can intensify capital flight and deepen the recession, with negative net consequences for fiscal income and stabilization. A more assertive tax policy will also frequently be accused of sending the wrong signals to the private sector; after all, the strategy that is fashionable today views most taxes as distortionary and welfare-reducing (Atkinson and Stiglitz, 1980).¹⁶

Privatization is clearly an expedient way to bypass the above dilemma. But using the privatization receipts to finance expenditure is analogous to borrowing. Thus, when used to finance current outlays, privatization reduces the public sector's net worth; moreover, this strategy only postpones rather than eliminates the need for further fiscal adjustment in the form of increased taxes or cutbacks in expenditure (Hemming and Mansoor, 1988).

The desire to finance fiscal deficits has been an important consideration in decisions to initiate privatization. Since money is fungible, it is difficult to isolate the use made of receipts derived from divestiture. Nevertheless, the existence of global fiscal deficits during periods of privatization is indicative of financing via divestiture, and moreover, deficits on current fiscal balances hint of some financing of current expenditures, inducing a direct loss of public sector net worth.¹⁷ Using these assumptions, privatization

¹⁵ Prior to being voted into power, the Peronist Party had opposed a partial privatization of ENTel which had been proposed earlier by the Alfonsín government (Gerchunoff and Castro, 1992).

¹⁶ This latter argument would seem to be almost irrelevant for Latin America, which already confronts huge disequilibria and distortions due to the crisis. Indeed, in such a "third best" world, it is difficult to assert that direct taxes will be distortionary.

¹⁷ It has been argued that privatizations are analogous to emitting bonds and therefore should be a "below the line" item in the fiscal accounts. Governments, however, tend to put privatization receipts above the line, thus causing the published accounts to understate deficits or overstate surpluses (Mansoor, 1988).

appears to have been used as a financing instrument in Chile in 1985-1986, in Argentina in 1989-91, and in Mexico in 1983-1990 (table 5).¹⁸ Also, the global surpluses registered in Mexico and Venezuela in 1991 would have been deficits without privatization receipts. As for the implicit financing of current outlays, this appears to have occurred in Argentina and Mexico up until 1991. More specific tracking of income and outlays in the case of Chile (Marcel, 1989) led to the conclusion that 50% of the Chilean privatization receipts in 1985-1986 went to finance current outlays, thus reducing the public sector's net worth. Finally it should be mentioned that a primary motive for the recent privatization operations in Venezuela and Peru has been the desire to relax severe fiscal constraints.

As a fiscal situation stabilizes, a country has more opportunities to use privatization receipts to finance reductions of public debt and to promote an overall improvement of net worth. In late 1990 Mexico began to earmark privatization receipts for a special fund, and a considerable amount of these resources has apparently been channelled to debt reduction: domestic public debt was reduced by US\$7 billion in 1991 and by US\$5 billion in the first quarter of 1992. Moreover, in 1992 the government quietly effected buybacks of US\$7 billion of public foreign commercial bank debt (equivalent to nearly 10% of the total public foreign debt) through the use of privatization receipts. It is estimated that total public debt, which in 1986 was equivalent to about 80% of GDP, was 29% of GDP by the end of 1992.¹⁹ Debt reduction became an important use for Chile's privatization receipts beginning in 1987 (Hachette and Lüders, 1992). The receipts from Argentina's initial round of privatization operations (1989/90) involved direct reduction of foreign debt, as a considerable part of the payment was made in promissory notes bought on the secondary market.²⁰ Much of the country's

receipts in the second round of privatization initially went to finance general expenditure, but with a fiscal surplus in 1992 more funds were being earmarked for reduction of public debt.

It is usually not easy to determine whether privatization has acted as a direct substitute for taxation. However, in Chile it is very likely that privatization financed the military government's fiscal reforms of 1984 and 1988, which sharply lowered direct and indirect taxes.²¹

c) *Investment constraints on public enterprises*

The fiscal crisis during the 1980s was seen as a serious obstacle to new investment in public firms and social infrastructure. As noted earlier, when the crisis broke, it was an easy matter to postpone the investments of PEs, and this was in fact done, in order to improve short-term financial balances (table 2). Even profitable public firms became prisoners of the central government's financial crisis. As the decade progressed, the investment lag became intolerable, especially in public services with a higher degree of visibility. As the public sector's debt problem persisted, privatization came to be perceived as a way to ease the public enterprises' growing investment bottleneck. In effect, through privatization a public firm could escape the central government's fiscal restraint and thus have more freedom to invest. Moreover, the receipts from the privatization could potentially allow the State to reinvigorate public social investment, or reduce debt. The investment bottleneck has almost always been used as one of the arguments for privatization, even in countries like Chile where many PEs were relatively efficient and profitable. As mentioned above, Mexico has laid special stress on the need to sell PEs in order to strengthen social investment.

d) *Catalytic effects.*

When an economy is in a deep recession, the public sector is traditionally expected to act in countercyclical fashion and stimulate activity through expansive monetary and/or fiscal policy. However, excessively procyclical public policies in Latin America were a major cause of the crisis; hence, when the crisis hit the region there were few degrees

¹⁸ There was an overall deficit in Brazil in 1991, but that country's privatization operations were paid for almost entirely in domestic public debt instruments. The Argentine privatizations of 1989/1990 were also paid for to a large extent with foreign public debt instruments.

¹⁹ According to the Minister of Finance of Mexico, as quoted in *Latin American Weekly Economic Report* (1992a).

²⁰ The privatization of ENTel and Aerolíneas Argentinas generated only US\$300 million of cash for assets valued at US\$1,500 million. This was due in part to the government's decision to receive payment in foreign bank debt, the nominal sum of which was US\$7 billion (Gerchunoff and Castro, 1992). The retirement of the debt had little effect on fiscal cash flow because the government was in a moratorium (Altimir and Devlin, 1992).

²¹ Some have characterized these reforms as regressive (Marfan, 1984).

TABLE 5

Latin America: fiscal balances for five countries^a
(Percentages of GDP)

	1983	1984	1985	1986	1987	1988	1989	1990	1991
<i>Chile</i>									
Current savings	-0.5	0.3	3.6	4.8	5.3	8.0	7.0	5.6	5.5
Total balance	-3.5	-4.6	-2.9	-2.0	2.6	3.9	5.5	1.5	1.7
<i>Mexico</i>									
Current savings	-2.8	-2.1	-3.4	-9.9	-12.2	-9.8	-5.7	-2.0	0.8
Total balance	-8.1	-7.1	-8.0	-14.5	-14.4	-9.7	-5.1	-2.9	3.4
<i>Argentina</i>									
Current savings	...	...	-1.9	-0.5	-1.7	-3.5	-1.6	-2.9	-1.6
Total balance	...	...	-5.4	-4.1	-6.7	-8.6	-4.8	-5.1	-2.2
<i>Brazil</i>									
Current savings	-1.4	-2.8	-8.1	-7.1	-6.1	-12.6	-20.1	-10.1	-10.0
Total balance	...	...	...	...	...	...	...	...	...
<i>Venezuela</i>									
Current savings	...	...	...	...	8.1	4.0	10.4	12.6	10.7
Total balance	...	...	...	...	-4.4	-8.6	-1.1	0.2	1.2

Source: ECLAC, *Economic Survey of Latin America and the Caribbean*, various numbers and Centre for Economic and Social Development Studies (CEDES), Buenos Aires.

^a Consolidated public sector.

of freedom for stimulative public action. Moreover, the new paradigm in the region discouraged public activism. In these circumstances privatization could be interpreted as an unconventional form of economic "pump priming".

A severe crisis, coupled with the uncertainty generated by a shift to a new economic model and radically different domestic relative prices, can cause the private sector to initially boycott its own domestic economy, by refusing to repatriate flight capital and by withholding taxes and investment. This obviously aggravates the fiscal problem and also is not a very healthy situation for a strategy in which the private sector is supposed to be the primary engine of economic growth. Privatization seems to have been viewed as a last resort to "stir the pot" and break the stalemate. As mentioned above, privatization can generate extraordinary receipts for the government which help it to close the fiscal gap. While fiscal balancing through privatization can be only a temporary strategy, it does buy time until more permanent financing can be found. Moreover, since the domestic private sector will purchase State assets by repatriating capital and foreign participants will bring their own dollars, a significant part of the privatization

receipts should be in foreign exchange. This will have the double-barreled impact of closing the fiscal gap and anchoring the exchange rate, both of which can be conducive to short-term price stabilization and better expectations.

It is also perceived that privatization can raise the private sector's disposition to save and invest. This is because it is usually less risky to buy existing firms than to invest in a start-up operation. Moreover, public firms often provide greater and more accurate information than can be found in other sectors of the economy. Another consideration is that many PEs, but especially those that provide public services in monopolistic or quasi-monopolistic markets, are inherently attractive low-risk and cash-rich operations in which shareholders can more easily appropriate a significant part of any efficiency gains. Finally, in a crisis environment the investment activity of highly visible privatized firms—even if not additive—could conceivably create positive externalities and help turn around the private sector's expectations.

Privatizations can also broaden and deepen moribund stock markets, give rise to windfall profits (especially when the firms involved are undervalued),

and generate new wealth and more optimistic expectations. This, coupled with the externalities of reinvigorated privatized firms and relaxed external constraints, can contribute to a recovery in the rate of domestic economic activity. More growth, in turn, will naturally boost fiscal revenue and also provide a better environment for fiscal reforms; consequently, privatization receipts can be gradually replaced with more stable sources of revenue.

Isolating and measuring all the catalytic effects of privatization operations is clearly an impossible task. Nevertheless, there are some judgements which point to probable catalytic effects of privatization. For instance, the World Bank has judged that the massive return of flight capital and influx of foreign portfolio investment in Mexico in 1989-1991 is largely a derivative of that country's privatization programme (Tandon, 1992). Mexico's stock market, one of the fastest growing in the world, has been stimulated by the privatization of PEs, particularly that of Telmex, which accounts for more than a quarter of the market's index (Ruprah, 1990a). Indeed, it has been commented that recent stock market developments have given rise to a whole new set of entrepreneurs.²² The investment activity of privatized firms, for example in the telecommunications, air transport and finance sectors, has also generated much publicity and international interest, perhaps contributing to the growing optimism in that country (Ruprah, 1990a and 1992b). Likewise, the second selloff of the residual shares of Argentina's ENTel also stimulated a boom in that country's stock market (Gerchunoff and Castro, 1992).

In Chile, Hachette and Lüders (1992) controversially attribute several catalytic effects to the second round of privatizations in that country, pointing to the fact that during that period, private savings and investment levels, although relatively low, rose quite sharply. According to these authors, this may have reflected the higher marginal rate of return on investment in privatized firms. The privatization process is also judged to have broadened, deepened and stimulated the stock market,

creating a dynamic new source of private wealth in Chile.

e) *Pacifying foreign creditors*

Privatization processes are strongly "encouraged" by the international financial community. A programme of this type could therefore enhance external economic relations, especially with the IMF, the World Bank and commercial lenders.

This consideration was probably important in Argentina's decision to initiate privatization in 1989, when there was a perceived need to pacify the commercial banks. In early 1988 the country had fallen into a moratorium, which was relaxed only marginally in 1989 by the initiation of partial debt service payments. A stoppage of payments traditionally raises tensions with foreign creditors, and indeed in early 1989 the banks were becoming more aggressive in their dealings with countries in a moratorium, as manifested by Citibank's "set-off" of some official deposits of Ecuador, another country which was limiting its debt service payments just like Argentina (Altimir and Devlin, 1992).

A privatization programme like Argentina's, which makes foreign debt paper an eligible means of payment, creates attractive options for the banks, especially the big lenders making up the Advisory Committees that are in charge of debt renegotiations. On the one hand, the banks gain by the rise in the secondary market price resulting from the increased demand for debt paper (in the case of Argentina, that price rose by some 50% during the finalization of the first round of privatizations). In these circumstances, banks can sell off their bad loans at a smaller loss and also gain commissions if they are contracted to secure paper for third parties interested in participating in the privatizations. On the other hand, a bank can avoid a loss on its own loan portfolio by capitalizing it through the purchase of a PE. It is no surprise, therefore, that some very large banks on Argentina's Advisory Committee were attracted by the sale of ENTel, and ultimately two of the country's major lenders, Citibank and Morgan Guaranty, actually bought major share holdings in the newly privatized company (Gerchunoff and Castro, 1992).

²² See Moffett, 1992.

IV

Improving the social benefits of privatization

Latin America had a very difficult ten years of structural adjustment and stabilization efforts in the 1980s, coupled with delicate transitions to democracy. Substantial progress has been made on all fronts. Indeed, in the early 1990s cautious optimism has arisen about the region's future prospects: Chile seems to have fully turned the corner towards economic recovery,²³ Mexico could be following a similar path, and a number of other countries are to different degrees consolidating their adjustment and transformation processes (ECLAC, 1991). The slow recovery from the crisis of 1982 has been socially very costly, however, as there are signs that income distribution and social equity have deteriorated sharply in many of the countries, most of which were already noted for their serious inequalities of income and opportunities (ECLAC, 1992a).

The deteriorated social matrix can be judged worrisome not only on normative grounds, but also in more concrete respects. On the one hand, the sustainability of the recovery will require social stability, and this in turn requires improvements in social equity. On the other, many dimensions of social equity are functional –indeed vital– to the construction of the modern institutional and human capital needed to transform the region's economies into truly internationally competitive enterprises (ECLAC, 1990 and 1992a). The recent serious political problems in Venezuela, Haiti, Brazil and Peru have focussed international attention on the social plight of the region and contributed to a surge in international concern about the effects of adjustment on social equity. The new focus certainly vindicates some analytical pioneers who argued a number of years ago that adjustment policies needed a more human face (Cornia, Jolly and Stewart, 1988).

The region's privatization processes are an integral part of the adjustment efforts. However, evaluating the effects of privatization is difficult because of, among other things, the large number of tradeoffs that

must be considered, the excessively broad nature of the relevant counterfactuals, and the difficulty in accounting for the externalities that many attribute to the process. But even more importantly, the privatization experience in developing countries is still relatively immature, even for pioneers like Chile; hence it will be a number of years before we really know all the resulting social benefits –and costs– of the region's decision to privatize.

Notwithstanding the above, the World Bank (Galal *et al.*, 1992) has attempted to grapple with some of these difficult problems. In a study of nine divestiture (privatization) operations in three developing countries, it found that eight of them improved global welfare. Thus, to its own question "did divestiture make the world a better place or not?", the Bank answers with a "resounding yes".

Needless to say, studies such as that carried out by the Bank involve numerous subjective judgements which many reasonable people could disagree with. But one conclusion can be drawn from the study without much debate: whatever the social gains from the region's divestitures have been and will be, they can undoubtedly be improved upon in future exercises.

In effect, divestiture processes have been conditioned by multiple objectives but, as has often been the case in questions of adjustment, social equity has not always carried much weight. This is unfortunate, because the tradeoff between social equity and other objectives can be relatively small, and indeed important complementarities would seem to exist. There are many ways that social equity can be enhanced in privatization exercises. While space is too limited for a comprehensive review, five key areas worth consideration are outlined below.

1. Transparency

Transparency improves social welfare because it reduces possibilities for corruption, collusion and the misuse of inside information, all of which permit privileged gains from the sale of public assets. It can

²³ Standard & Poor have just given Chile a BBB investment rating.

also be complementary with many other objectives. Since transparency opens the process to more public scrutiny, errors can be checked more easily and fairer evaluations can be made as to whether the government's stated objectives—regarding the privatization process as well as its end product—are being reasonably fulfilled. The closer results are to objectives, the more likely it is that privatization will have a "happy ending" for the firms, the government, and the general public, which in turn reduces the risk of policy backlash. Transparency also enhances the efficiency of the "learning by doing" process which is an inevitable part of any government's privatization programme. An enhanced flow of information will obviously also contribute to overall market efficiency and price maximization.

Transparency can also enhance the government's credibility and have catalytic effects, especially when past governments have had a reputation for corruption or cronyism. It is also consistent with the objective of democratization and broader participation in economic matters and in society more generally.

Of course, transparency trades off with the speed of the privatization process. This could be an important consideration, since some analysts have given top priority to this latter objective; as one highly regarded economist once commented: "privatization should be implemented with less concern about the correct way to do it and more emphasis on getting it done quickly" (Woodrow Wilson Center, 1991). However, most of the objectives that commonly drive privatization processes are not necessarily enhanced by speed; indeed many of them, such as productive and allocative efficiency, credibility, government revenue, catalytic effects, etc., to say nothing of social equity, can be seriously compromised by a hasty privatization process.

Most governments in the region have confronted very heavy external, and sometimes internal, pressure to greatly accelerate their privatization processes. It is encouraging that some have been able to resist such pressures, while at the same time proceeding in a deliberate fashion with their objective of privatizing PEs.

The conflicting pressures that governments face are captured in the remarks of a person who was formerly in charge of privatization efforts in Brazil, a country with one of the more transparent programmes: "...one can always choose urgency, make bad shareholder decisions, leave significant debts

pending, reduce the minimum price, etc. These, however, are not good recipes for a successful privatization programme. Indeed, they are detrimental to the principles of openness and transparency, as well as to the public wealth (represented by the assets being sold off). We chose to go about things carefully. Right from the start, we knew that this would result in us having to pay a political price: the ever alert critics, those who are not committed to openness, and even analysts who have good will, yet suffer from academic ingenuousness, would condemn the supposed sluggishness of the process. I do not have the slightest doubt, however, that we made the correct choice" (Marco Modiano, 1992).

While more transparency may be feasible, there is at least one area where the tradeoffs can be exceptionally great: fiscal urgency (earlier termed the "Pan Am" effect). Social welfare demands that a country with a highly destabilizing fiscal gap must close it as soon as possible, and a rapid privatization process could conceivably be the only way to do that. However, experience has shown that rapid processes can be prone to very serious errors (Hachette and Lüders, 1992; Gerchunoff and Castro, 1992); indeed, emerging problems such as corruption, undervaluation, etc. could conceivably neutralize the positive effects of financing the fiscal gap. But the mentioned tradeoff is nevertheless very real and is frequently a challenge for the region's policy makers.

In the face of fiscal urgency, one possible alternative to a rapid privatization process is a non-confrontational moratorium on foreign debt payments. However this is a tricky strategy in which only a few countries have been successful (Altimir and Devlin, 1992). A better public solution would be to strengthen the resource base of the World Bank, IMF and IDB, for this would enable the multilateral organizations to provide more direct compensatory budgetary support to governments formally committed to extensive privatization processes. As is true with the adjustment problem in general, adequate compensatory financing will allow a borrower to design a more deliberate, transparent, efficient and socially equitable privatization programme. This should also be of interest to the multilateral lenders, because more efficient and equitable programmes will clearly enhance their borrowers' creditworthiness.

What actions could improve transparency? The potential list is long, but a few key policies can be mentioned:

i) *Information.* Reserved documentation should be the exception rather than the rule. While a limited amount of reserved information may be justified during negotiations for the sale of PEs, the public should have easy access to all the information after the transaction is completed, including the preparations for the sale of the firm (debt absorption, labour relations, capital restructuring, etc.), reports on its valuation and on the preselection and selection processes, administrative and promotional costs, and details of the buyers and their financing of the purchase.

ii) *Subsidies.* If sales require subsidies, these should not be hidden in preferential prices and credit terms. Rather, subsidies should be awarded in such a way that they are explicit and easily accountable to the public (e.g., rebates which must be applied for *after* the firm has been purchased at an unsubsidized price). This is an important consideration because a double standard has tended to emerge during the period of privatizations: proponents of structural adjustment rankle at hidden subsidies in the social area but turn a blind eye to subsidies hidden in underpriced asset sales and below-market credit terms.

iii) *Earmarking of sale receipts.* These should be deposited in a special account (Mexico has done this). While earmarking is often frowned upon in public finance, it is justified here by the extraordinary nature of the income.

iv) *Ex-post evaluation.* An independent official technical agency (as opposed to a merely formal legal entity) should be responsible for ex-post evaluations of individual privatization operations, on the basis of *ex-ante* agreed criteria formulated jointly by the Congress and the Executive branch.

v) *Rules on disclosure.* Privatized firms should sometimes be subject to certain special disclosure rules which facilitate access to the types of information needed for effective *ex-post* evaluation of the results of privatization.

vi) *Conflicts of interest.* An explicit code of conduct should be adopted for government officials and subcontracted technicians involved in the decision to privatize and the process itself. For instance, central government employees involved in privatization operations could be prohibited from working in privatized firms for a given period, e.g., five years. Also, such government employees (including executives of the firms to be privatized) could be prohibited from owning shares in privatized enterprises for a stipulated period.

2. Price maximization

It must be remembered that the government's revenues are a key determinant in the welfare gains from privatization (Jones, Tandon and Vogelsang, 1990). Thus, when public assets are for sale, prices must be maximized as much as possible. Price maximization is important because it eliminates hidden subsidies for privileged buyers and keeps public wealth in the public domain where it can be used for consensual public purposes. Unfortunately there is some evidence that privatization processes suffer from a tendency to seriously underprice the State's assets (Vickers and Yarrow, 1988; Seth, 1989; Marcel, 1989; Errázuriz and Weinstein, 1986; Herrera, 1991; Gerchunoff and Coloma, 1992). Another possible indicator of underpricing can be indirectly inferred from the aforementioned World Bank study (Galal *et al.*, 1992): of the total of four countries studied, only in Malaysia—a very cautious privatizer—was the government consistently a bigger winner in the privatization operations than the new private shareholders.

The price maximization strategy is conditioned by some important tradeoffs between these and other factors, as mentioned further on. Some central considerations for maximization are presented below.

i) When selling a firm, the price does not depend on its value to the public sector, but rather its alternative value as private property. Thus, the point of reference for price maximization should be an estimate of the firm's value to the private sector. This will usually be higher than the value of the firm for the public sector, due to efficiency differentials, synergies, opportunities for diversification, etc.

ii) The following sequence should be followed as far as possible: privatization should come near the end of the adjustment process, that is to say, after liberalization, correction of relative prices, settling down of interest rates to their long-term values, introduction of legal frameworks governing property, labour and market behaviour, and after economic recovery has already begun. In this way, the real value of the firm will be more apparent, private sector risk premiums will be less distorted, and the privatized firm itself will be more likely to be successful. Privatization should initially focus as much as possible on the tradeable goods sector—where learning by doing can have lower costs—and only later progress to any big public service firms which may be

earmarked for privatization.²⁴ Saving enterprises in the non-tradeables sector for the later stages is also useful because their sale will thus coincide with a period when exchange rates are probably appreciating with respect to the levels registered during periods of adjustment and thereby raising the relative value of the types of services they produce.

iii) Public firms, but especially large ones, should be restructured before sale, introducing reforms that are reasonably feasible and that enhance efficiency and profitability (Martín del Campo and Winkler, 1992). This will make the value of the firm more visible to the private sector and also raise the bargaining power of the seller, because it is easier to hold out for a higher price when a firm is commercially viable. Even when no reforms of the PEs are feasible, official valuation exercises should not necessarily be based on the firm's value "as is", since at least some of the private sector's reforms can be easily anticipated. Moreover, "normal" market discount rates should be used when valuing firms. In this way, the costs of undertaking a sale when private discount rates are distorted and unusually high become clear to the public. This approach moreover could raise political pressure for more optimal preparation, sequencing and pricing of sales.

iv) Firms should be sold to the highest bidder, minimizing as much as possible considerations that go beyond objective efficiency. Efforts should be made to attract as many bidders as possible: sometimes this may point to the desirability of encouraging foreign participation by such means as placement of shares on international stock and American Depository Receipt (ADR) markets. Sales on preferential terms should be avoided: as mentioned earlier, if subsidies are deemed necessary, they should be given directly and explicitly, separately from the sale transaction itself.

v) Since fixing the correct price is often a process of trial and error, there can be an advantage in selling shares in small packages that are timed to avoid market saturation and capture the best price. Beginning a privatization operation with the sale of a controlling package has been shown to maximize receipts in a number of cases; in effect, the transfer of control to a good operator, and/or favourable evolution of the

economy, can raise the value of the firm and allow the government to share in the gains through a later contingent sale of its residual share holdings.²⁵ Mexico's pursuit of this strategy was rather clever: it involved prior restructuring of TELMEX's capital so that voting control could be had for as little as 21% of the company's total shares; this raised the number of financially eligible bidders and later helped maximize the price of the government's contingent selloff of residual shares.

vi) Payment should be demanded in cash. Payment in debt paper has several disadvantages. First, it erodes transparency, since it is hard to determine the real value of the debt instrument. Second, payment in foreign debt can narrow the competitive base of bidding, since some potential bidders will not have easy access to the secondary market, while others (especially banks) will have exceptionally good access. Third, if reduction of foreign debt is an important goal, it would seem more efficient to follow Mexico's example: accept only cash sales and use the receipts to negotiate a concerted Brady deal and/or discreetly withdraw debt paper from the secondary market in such a way that it puts minimum pressure on prices. Fourth, as far as pacifying banks irritated by arrears is concerned, the need to do so on a grand scale may be exaggerated, as the banks have shown only limited ability to retaliate beyond the starting of a manageable brush fire (Altimir and Devlin, 1992).

vii) The State can retain a special "golden" share in a privatized firm, designed to entitle it to share in profits if, in the future, the yield of the enterprise exceeds some mutually agreed level. The "golden" share is a contingency formula which obliges both parties to share in the risk of privatization. This could be a useful strategy when a PE must be sold in adverse market conditions. This option could initially depress the sale price, but it would at the same time enhance the probability of a happy ending for the firm and recovery of the property's value for the State at a later date.

As already mentioned, price maximization must trade off with other objectives. However, once again the tradeoffs do not always have to be large and indeed one can find complementarities.

²⁴ Mexico, but especially Chile in the period 1985-89, followed this sequence (Martín del Campo and Winkler, 1992). Brazil has so far also been broadly following this path.

²⁵ This strategy has worked in Argentina and Mexico (Gerchunoff and Castro, 1992; Ruprah, 1990a).

There can obviously be a serious tradeoff between price and efficiency. The highest bidder is not always the most efficient operator (in a dynamic sense, which includes the operator's propensity to invest). Moreover, a higher price will be fetched for a firm with effective monopoly power than for one facing effective competition or external regulation. In sum, it is reasonable to condition price by dynamic internal and allocative efficiency criteria, since efficiency is the other major missing ingredient in Latin America's needed economic transformation (ECLAC, 1992a).

Price is often sacrificed for a specially targeted distribution of shares. Two prevalent target groups have been small investors (popular capitalism) and workers (labour capitalism). The former are ostensibly targeted to democratize capitalism and improve the efficiency of markets. The latter are targeted ostensibly to enhance productivity.

Popular capitalism, at least as sometimes practiced in the region,²⁶ raises legitimate questions about whether the implicit price subsidy is, socially speaking, really worth it. First, unless there is a virtual giveaway of the public firm to every citizen, there is reason to suspect that in a poor developing country the so-called popular capitalism will not be so popular.²⁷

Second, one of the technical justifications for promoting popular capitalism—discouraging market-efficient takeover threats—is weakened when the main motive for share participation is not risk-adjusted future

returns but rather exploitation of an easy and almost guaranteed rent.²⁸ On the one hand, the rent seekers have less incentive to be well-informed shareholders, making them prone to herd behaviour and exit.²⁹ On the other, uninformed and dispersed shareholders create favourable conditions for the emergence of an organized group that may take entrenched control of the firm; moreover, the group may well pay a price that is lower than if control had been sold by open bid at the time of privatization.³⁰ It should also be mentioned that the debate over whether concentrated or dispersed ownership is more effective for international competitiveness is by no means resolved (especially in the context of a developing country) (Akyuz, 1992; Welch, 1992), thus making popular capitalism something of an act of faith.

Third, if monetary incentives are deemed necessary to promote capitalist values (of course there may be better ways), it is more transparent and equitable to sell the shares at the highest possible price and offer the possibility of applying for clearly identifiable rebates that make the subsidy explicit and accountable to the general public. Of course, none of these considerations apply if popular capitalism is really a ploy to gain political or ideological advantages; in that case, the hidden subsidy may be a quite effective, albeit cynical, tool.³¹

Privatization operations have often transferred shares to the firm's workers on preferential terms. Chile probably has the region's most extensive experience in this area, but the strategy has appeared on

²⁶ A number of countries in the region have engaged in preferential distributions, but Chile has clearly been the main practitioner of this strategy. During the military regime preferential sales to the general public and public sector workers (including the Armed Forces) created some 120,000 popular capitalists (Sáez, 1991).

²⁷ Our examination of the home addresses of 46,000 popular capitalists in one of the largest Chilean privatization operations (the sale of the ENDESA electricity firm) suggests that it is extremely likely that there was disproportionate participation by upper income groups. This conclusion is based on the distribution of popular capitalists in the different municipalities of Santiago, a highly socially-stratified city with 40% of the country's population. About 45% of the shares sold to the popular capitalists (at a preferential price and with subsidized credit) were purchased by residents of this city. Of that amount, slightly more than 50% were bought by residents of four municipalities where nearly 70% of the households are in the top two income distribution deciles. (The primary data on popular capitalism came from CORFO, while data on income distribution were provided by Arturo León, of ECLAC's Statistics and Projections Division).

²⁸ Regarding the preferential sales of ENDESA shares, the official brochure distributed to public employees stressed that "the offer involves no cost to the workers" (CORFO, 1988).

²⁹ There are signs of erosion of the small shareholders' base in Chile's privatized firms; for example, ENDESA's small shareholders declined by 11% between 1989 and 1991.

³⁰ In 1989, the holding company ENERSIS was set up and gained control of ENDESA with 12% of the company's total shares. The price paid was quite attractive, since share prices were relatively depressed at the time of the purchase. See Sáez, 1991.

³¹ In Chile, the authorities also viewed popular capitalism as a way to discourage renationalization (Hachette and Lüders, 1992) and perhaps gain an advantage in the upcoming 1989 plebiscite. Popular capitalism in England also apparently had political objectives (Vickers and Yarrow, 1988).

a lesser scale in most other countries as well.³² The technical logic behind labour capitalism would seem to make most sense only if the workers gain a large enough block of shares to hold and sustain representation on the board of directors of the privatized firm. But in this case, since workers possess "inside" information about the firm, there would obviously be little reason to subsidize the price of their shares and credit. On the other hand, if workers receive subsidized shares without board representation, they could conceivably suffer in the medium term as short-term capital gains could erode a trade union's discipline and effectiveness as a collective bargaining tool.³³

The preferential distribution of shares to workers in the region has usually not been large enough to give them sustained representation on the board of directors. In reality, the underlying motive of the offer usually seems to have been the reduction of labour's resistance to privatization: a strategy which has tended to work quite well. However, if the main purpose of a subsidized share distribution is to co-opt workers, a more efficient alternative might be to simply link the privatization to the establishment of a profit-sharing arrangement for them, thereby reserving the sale of shares for the highest bidders. This approach could improve the net sale proceeds for the State, as it avoids the lower sale price deriving from the subsidy given on the shares distributed to workers and the uncertainty that prospective shareholders might feel regarding the future role of workers in the

management of the firm. Moreover, a profit-sharing programme could have larger spread effects in the local economy than a special subsidized sale of shares to workers of certain public enterprises. In effect, it establishes a precedent that other private firms can more plausibly be encouraged to imitate, which in turn opens up prospects of institutionalizing profit-sharing for all workers in the productive sector of the economy. Finally, as an incentive to productivity, profit-sharing for risk-shy workers may be better than a gratuitous distribution of shares because it avoids the problems of worker morale that can arise from unfavourable fluctuations in the region's still thin and volatile domestic stock markets.

The objective of price maximization could also conceivably trade off with a subsidy for capitalists, designed to serve as a catalyst for private sector investment and growth. While this particular tradeoff finds some support in certain technical circles, the awarding of rents to a select group of domestic capitalists in order to stimulate the overall economy's animal spirits is certainly a controversial hypothesis that is difficult to test. If subsidies are deemed necessary it is clearly more efficient and equitable to grant them directly in the form of a tax credit or other publicly accountable instrument. In any event, the externalities derived from hidden subsidies in a privatization operation are probably exaggerated and far less important than those emerging from sound overall public macroeconomic and social reform programmes (which can be aided by a share price maximization strategy), astute international bargaining and fortuitous exogenous events.³⁴

A price maximization strategy should also be compatible with the objective of projecting political credibility. Once again, a conflict could arise most easily in cases of great fiscal urgency. This is yet another reason why greater transitory direct compensatory budgetary support should be forthcoming from the international financial agencies.

³² In Chile at least 15 privatization operations offered shares to workers on preferential terms. Although the amounts of shares varied, the general pattern was that a few small firms (e.g., subsidiaries of ENDESA) were sold entirely to workers, while employees of large privatized firms were given small blocks of shares ranging from 6-10%. Major exceptions were CAP, where workers secured more than 30% of the shares in a highly controversial transaction (Errázuriz, Fortunati and Bustamante, 1989), IANSA (21%), and LAN Chile (15%). In a few privatization operations workers joined together of their own initiative to borrow resources in financial markets and purchase additional shares. However, even in cases where workers nominally gained a large block of shares it is difficult to ascertain to what degree they participated in decision-making, because shares often came to be managed by investment trusts. In Mexico, workers have also occasionally participated in sales: for example, they were sold 4% of TELMEX, in the country's largest privatization operation. In the case of Aeroméxico, the pilots' union secured 35% of the firm (Ruprah, 1992b). In Argentina, 10% of a privatized firm's shares are frequently earmarked for workers.

³³ My thanks are due to Hernán Gutiérrez for this latter observation.

³⁴ Privatization operations do not seem to have been the decisive factors in economic recoveries. In Mexico, the decisive factor appears to have been the announcement of the North American Free Trade Zone, coupled with a coherent and tough adjustment/stabilization programme (of which privatization was a part). In Chile, the recovery was underway before privatization began. This, coupled with a depreciating exchange rate, could be the principal reason behind rising private savings and investment. Recovery in Venezuela, for its part, was set off by the favourable effects of the Gulf War on the petroleum sector, coupled with a draconian adjustment programme.

3. Assignment of privatization receipts to a social development trust fund

If there were absolutely no alternative role for the State, the outcome of a privatization process would be a proportionate shrinking of the public sector. However, even if one were to make the extreme assumption that there is no future direct role for the State in productive activities,³⁵ there would still be a serious need to strengthen public goods in the social area. Indeed, after ten years of regressive adjustment in the region, most would concede that the social sector (including public infrastructure) is one area where the State should focus its future efforts. While in some instances support for social development could be provided by imaginative private initiatives, there is often no satisfactory alternative to public action.

In the social area it is not always easy to distinguish conceptually between current and capital outlays. Nevertheless, from an accounting standpoint, recurrent social expenditure has suffered most during the crisis, and in relative terms it is here that financial support is most urgently needed in the years ahead (ECLAC, 1992c). Thus, in addition to earmarking privatization receipts for a special account, it might be helpful to further earmark all, or at least a significant part, of the income for a national social development trust fund. This type of policy would establish a permanent and flexible base for increased social expenditure on either the current or capital account.³⁶ Of course, earmarking might be hard to accomplish when there is a general situation of fiscal urgency, but on the other hand, if authorities were legally required to earmark their extraordinary income for social expenditure, this could serve as a political tool to focus attention on other ways to balance budgets, e.g., tax reforms, cuts in excessive military expenditures, or more aggressive debt renegotiation strategies.

³⁵Of course, in practice, there probably is a future role for State enterprises due to the infant industry argument, considerations about strategic macroeconomic management, regulatory requirements for firm-level information in oligopolistic public service sectors; public choice, etc. Indeed, as Lahera (1992) has commented, there should be a flexible conceptualization of State participation in the economy. If the State's entrance into economic activity is easy and its exit difficult, there are probabilities of eventual inefficiencies and rents. On the other hand, if entrance is impossible and exit easy, the activity of the State will not always be compatible with development.

³⁶My thanks are due to Martine Guerguil for sharing with me her idea about a trust fund.

4. Fair compensation for PE employees

As an alternative to a strategy of layoffs followed by new hiring, greater efforts could be made to exploit possibilities of retraining and redeploying labour within the firm. Shares with representation on the board of directors, or profit-sharing, could be exchanged for concessions on wages. When systematic layoffs are necessary in privatization programmes, indemnification is simply not enough.³⁷ Cash payments can easily be squandered; hence, the workers affected need counselling, retraining, relocation assistance and follow-up monitoring of their reintegration into the market. Since redundant employment in State firms is a "public problem", it would seem appropriate to finance retraining, counselling and indemnifications with special solidarity taxes or soft loans from international development banks, which incidentally have historically been major creditors of many PEs.³⁸

³⁷Information on the fate of workers is an area of analysis that needs much more attention. Mexico's latter rounds of privatization operations were characterized by the official objective of avoiding layoffs; for instance, in the privatization of TELMEX, with 49,000 workers, there were no dismissals. This was due in part to the workers' acceptance of changes in labour contracts and the government's decision to establish a retraining facility within the firm for employees displaced by new technology. On the other hand, the peaceful tone of industrial relations was also influenced by demonstration effects: in 1988, as a prelude to privatizing Aeroméxico, the government confronted a striking union by suddenly declaring the firm bankrupt. The workforce dropped overnight from 12,000 employees to less than 4,000 (Ruprah, 1992b). Moreover, Mexican unions claim that 100,000 workers have lost their jobs either through direct privatization or through rationalization of State agencies (*Latin American Weekly Report*, 1992b). In Chile, privatization operations were not generally associated with massive layoffs; indeed employment in many firms expanded. However, the workforce of public enterprises had already been drastically reduced in earlier public enterprise reforms; by 1986 the labour force in major public enterprises was 40% less than it had been in 1974 (Sáez, 1991). In Argentina, although there has been a layoff of workers as part of the preparation for the privatization of a steel complex, the general strategy has been to cancel labour contracts and let workers renegotiate them with the privatized firms. The outcome of this process should be studied in order to ascertain how workers have fared in their new contractual limbo.

³⁸The World Bank has financed indemnification payments in some countries.

5. Effective regulation

From the standpoint of social welfare, a key assumption of successful privatization is that firms can be regulated externally by the public sector as well as or better than when they were under direct public ownership. However, the transfer of ownership creates new types of problems that must be surmounted.

It is often argued that liberalization of trade is sufficient to regulate tradeable goods sectors and ensure reasonable internal efficiency. However, this may be only partly true in a developing country, as there will be lags and remaining obstacles to price competition on account of, among other things, the small size of many markets, which creates price inelasticities; the upfront costs of establishing distribution networks; exclusive dealership arrangements; collusion; and the considerable transport costs in South America. Thus there will be a need for new domestic institutional and legal structures to promote desirable levels of competition and to control arbitrary pricing strategies, especially in the case of durable goods (technical norms for quality and consumer safety are, of course, also desirable).

As far as large public service firms are concerned, the usual strategy up to now has been to transfer public monopolies into private hands. This is not necessarily a bad decision; in spite of recent arguments which have undermined the strength of the traditional natural monopoly concept, in some sectors there is still legitimate room to debate the effects of deconcentration on allocative efficiency. In effect, a developing country may not want to assume the risk of experimenting with the breaking-up of integrated public service systems.

Notwithstanding the above, the new regulatory frameworks which have emerged in the region's privatization of public service sectors often allow for new entrants, which introduces the assumption of an immediate or future contestable market. However, when the dominant operator in the market is very large, it, rather than the potential new entrant, is the real threat to the market, so that in many cases the practical relevance of contestability as a serious regulatory factor is suspect (Vickers and Yarrow, 1988). Thus, even if a market is contestable in principle, effective direct price/quality regulation of the new privatized industries by public authorities is of paramount importance for allocative efficiency and social equity.

The region's regulatory challenge is a major one, especially in public services. First, effectively regulating powerful monopolies is inherently a difficult and sometimes conflictive task which can test the mettle of even the most zealous regulators and sophisticated government administrations.³⁹ Second, the speed with which regulatory systems have emerged in Latin America suggests that flaws are likely to be discovered in them after privatization, and when these are serious, countries will have to find ways to correct them without disrupting investment or the stock markets, where privatized public service firms usually carry much weight. Third, regulatory systems must also be flexible in face of the fast changing technological developments in some public service sectors. Fourth, regulators may also have to be international diplomats, as many new owners of public service firms are foreign enterprises and many of the latter are owned by foreign governments.

The signs are that the region's regulatory capacity is lagging far behind the speed of its privatization processes. The problem is not so much the lack of formal systems—they are often quite sophisticated and imaginative, as in the case of the Chilean electricity sector (Banlot, 1993)—but rather that they are emerging with little or no track record and apparently weak or non-existent enforcement systems.⁴⁰ The problem is aggravated by the fact that, in order to attract buyers and finance their investment commitments, scales of charges were often subjected to prior adjustments which were extremely generous to the privatized firms.⁴¹

When regulatory frameworks are permissive, this could mean that the authorities have decided to trade off the improved internal efficiency of a privatized firm against a potential deterioration in allocative efficiency, wagering implicitly that the loss of static

³⁹This has been shown by the experience with companies like British Telecom, British Gas, etc. (*The Economist*, 1992).

⁴⁰For the cases of Mexico and Argentina see Ruprah (1990a and 1992b) and Gerchunoff and Castro (1992), respectively. The Chilean systems have a track record, since they were first established in the early 1980s; even so, there has been much confusion in the interpretation and enforcement of the different systems.

⁴¹See Gerchunoff and Castro (1992) and Ruprah (1990a). In Chile, rates underwent severe adjustment well before privatization. It should be mentioned that the investment constraint argument in respect of privatization is weakened when the main source of finance for new investment is government-authorized increases in the scales of charges.

allocative efficiency and social equity will be more than compensated by the catalytic effects of the enhanced profitability of capital in the privatized sector. Unfortunately, from the standpoint of equity this could be another version of the "trickledown" approach to development that tended to dominate thinking in the 1980s. Moreover, it assumes that the tradeable goods sector can prosper even with potentially significant distortions in the relative prices of important domestic public services.

Key ingredients for success in regulation include the following:

i) Regulatory systems should be set up well before the privatization of a public service firm (Paredes, 1992) so that a track record can be established and some of the worst operational problems can possibly be ironed out while the firm is still State property. At the very least, it would be wise to avoid the simultaneous privatization of several public service sectors which still have "virgin" regulatory systems.

ii) Regulatory systems should be based on straightforward, impersonal rules that are clearly defined, technically consistent with the administrative skills of the country's prospective regulators, and comprehensible not only to shareholders and management, but also to consumers; sophisticated regulatory systems which may offer a great deal of theoretical satisfaction may in practice create more regulatory problems than solutions.

iii) Regulatory systems in developing countries must be designed to take into account dynamic and not just static efficiency.

iv) Regulatory bodies should be independent public entities whose board appointments should be staggered so as not to coincide with political cycles.

v) Regulatory personnel should be technically qualified, very well paid relative to the industry that is being regulated, and prohibited from working in the regulated industry for a specified period after their appointments are terminated.

vi) The regulatory board should have fluid channels of communication with its relevant industry, but at the same time it should always have the last word on regulatory decisions.

vii) A special legal framework should be established to settle disputes between firms and the regulators.

viii) The regulator must have a clear, practical, and increasingly severe set of sanctions at its disposal in case of a firm's non-compliance.

ix) Reviews of the regulatory framework for public service sectors should be spread out over an extended period so as to avoid the bunching of review sessions; in this way potential disputes could be less damaging to overall economic confidence.⁴²

It is often overlooked that an essential public service can never be fully privatized, because the operator of last resort will always be the public sector. To avoid the moral hazard that could affect private owners, the State should probably consider regulating privatized firms more comprehensively than is traditionally the case, including their debt accumulation, dividend policy, diversification and investment. An alternative would be to forego more comprehensive regulation but charge the privatized firm a risk premium for "public insurance" covering the contingent costs of State intervention should the firm enter into a critical operating condition. The moral hazard problem could be more volatile in regulatory frameworks that copy England's RPI-X formula,⁴³ because unexpected shocks arising from bad management decisions and/or exogenous factors cannot be passed on to prices. Finding commercially viable ways to control moral hazard is admittedly a difficult task. However, ignoring the problem could mean seriously underestimating the costs of privatization.

Finally, it could be argued that effective regulation will lower the sale price of PEs, compared with firms granted extensive market power. But perhaps the tradeoff is not all that large, since astute purchasers will surely discount the effects of excessively permissive regulatory frameworks that will very likely be subject to serious adjustments at a later date.

⁴² Long periods between review sessions could, however, create the need for very large adjustments. An alternative worth considering is a continuous review process which induces mini-adjustments, much like a crawling peg exchange rate system.

⁴³ This formula means that regulated prices rise on average by less than the rate of domestic inflation (the Retail Price Index - RPI). This is supposed to be an incentive for innovation and cost reduction. However, there may be little room to absorb shocks such as a failed project, debt refinancing problems, etc. The telecommunications sectors in Argentina and Mexico will be regulated by variants of the RPI-X formula. In the case of Argentina, however, there are adjustments for adverse movements of the exchange rate. See Gerchunoff and Castro (1992) and Ruprah (1990a).

V

CONCLUSIONS

Privatization is now a fact of life in Latin America. Most of the countries' programmes are very ambitious, and there is little sign of the trend slowing down before a large part of the region's PEs have been divested. The theoretical and practical benefits of divestiture in a developing country would seem to be strongest in most conventional tradeable goods sectors, where liberalized markets can be counted on to autonomously perform a large part of the regulatory function (hopefully complemented by anti-monopoly laws and consumer protection norms). In contrast, they are more problematical in sectors involving capital-dense public services, or those which have large externalities for macroeconomic management; in these cases, the impact of divestiture on social welfare will be intimately linked to the ability of governments to administratively regulate the privatized firms on a continuous and effective basis.

Clearly, the poorer a country and the more unsophisticated its public administration, the greater the need for caution in the decision to divest large public service firms.⁴⁴ In any event, only time will tell the degree to which the actual process and end product of divestiture improves social welfare. Whatever the benefits to be had from privatization, however, they can be improved upon if more attention is given to the objective of social equity.

We have focused proposals on five key areas that can raise the social benefits of privatization: greater transparency; more systematic efforts to maximize the sale price; fair compensation for displaced workers; the earmarking of sale receipts for social development, and effective public regulation.

Of course, social equity must trade off with other objectives. However, the tradeoffs with many

of the commonly stated objectives of privatization do not necessarily entail major sacrifices in terms of equity, for many complementarities would seem to exist. In fact, the most threatening tradeoff seems to be fiscal urgency. Thus, it would be helpful if multilateral organizations strengthened, or at least front-loaded, their budgetary support for developing countries willing to initiate a careful and socially equitable divestiture programme. This can be justified on grounds which these organizations readily understand: improved creditworthiness of their borrowers.

In sum, reform of public enterprises through privatization is necessarily a complicated task that must balance real tradeoffs. However, the prime factors in deciding on privatization should be social equity and dynamic efficiency, and these considerations should be traded off for other objectives only reluctantly and in ways which make not only the benefits but also the social costs of the decision explicit to the public. Latecomers in privatization can clearly learn lessons from more advanced programmes on how to improve the net social benefits of the process. Nevertheless, even the best privatization schemes will probably leave some problems that will have to be mopped up by later governments. In view of this, privatization should be seen not so much as an "event" but rather as a "process" in which one can expect that the divestiture of PEs will produce the need for other reforms, especially in the regulatory area. The success of governments in managing this latter transition will also be an important determinant of the net social benefits of privatization.

⁴⁴ Other alternatives might be explored, such as performance contracts for public firms or payment of fees to an experienced private operator who undertakes to pursue publicly outlined objectives.

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