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**THE DOG IN THE MANGER:
DEFINING THE STATE'S ENTREPRENEURIAL ROLE IN LATIN AMERICA**

Carlos A. Patrón*

Peruvian sources of fresh water supply are abundant, yet Peruvians have the second lowest level of access to piped water and sewerage in South America. Only 72 percent of households have piped water (but don't dare to drink it from the faucet) and only 51 percent have access to sewerage. According to government figures, 40 percent of piped water is not billed because of leaks and unauthorized connections.¹ Current estimates project that Peru needs to invest US\$4.6 billion in infrastructure just to reach the levels of piped water and sewage of Colombia and Chile.² Opposers to the privatization of the state-owned Peruvian water and sewage system (mainly the government enterprises' labor unions and advocates for middle class consumers with access to piped water and sewerage) argue that water is a human right, not a commodity. Meanwhile, per each cubic meter of water that is delivered by tanker-trucks, the less fortunate (about ten million of them) pay roughly ten times the amount charged by government enterprises to piped water users, as dengue-fever (a *tropical* disease) outbreaks have become common in the lower-income settlements located in the *desert* areas outside of Lima due to lack of sewerage.

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¹ See Private Investment In Peru's Water Industry, *The Economist* (February 16th, 2006), at 36-38.

² Estimates by the *Instituto Peruano de Economía*.

The preceding example sets the stage for the question we wish to address in this paper: Is *entrepreneurship* an appropriate role for the State in Latin American Countries ("LAC")?³ We contend that there is a solid theoretical and empirical basis to sustain that it is not. While there is a growing sector that opposes furthering privatization efforts carried out in the region over the past two decades, we argue that public perception is largely fuelled by shortcomings rooted in policy implementation mismanagement of past divestiture processes that does not invalidate the premises upon which privatization of state-owned enterprises ("SOE") stands. It does, however, reveal the paramount importance of introducing policies to foster greater transparency and political accountability into the divestiture processes and to strengthen the regulatory and institutional framework under which privatized firms must endure, all of which will require greater civil community involvement and citizen oversight schemes, effective communication, profit-sharing, inclusive dialogue and consensus building with labor and other interest groups.

The paper is organized in four sections. In Section I, we outline the main common characteristics of the political economy under which SOE emerged, developed and ultimately withered in Latin America, touching on the goals drafted to justify the State's entrepreneurial role in the region, as well as the common features of SOE performance prior to 1982. In turn, in Section II we discuss the theoretical shortcomings of state ownership and sketch a rough assessment of the costs and reputed benefits of the expansion of SOE in the region. Section III is centered on the process embarked upon by most LAC over the last two decades to unravel the State's entrepreneurial role, discussing its motivations, successes and shortcomings. In

³ In this paper, we use the term "entrepreneur" and its variations to refer to the individual who undertakes the activity of, and assumes the risks associated to, organizing the standard means of production (capital, labor, land) and coordinating production and distribution of goods and services demanded in the market.

Section IV, we conclude by briefly reflecting on the future of the public-private ownership debate in the region.

I. The Political Economy of the Rise and Fall of SOE in Latin America

As was the case in other less developed parts of the world, SOE in Latin America arose and expanded as a result of a mix of political, economical and ideological reasons.⁴ In general terms, by the end of World War II, the support of the export-led growth model that had endured throughout Latin America in the previous decades had weakened and dwindled as a result of the consequences of the exposure to external shocks that had plagued LAC's economies in the past.⁵ At the time, the growing consensus in the region concerning the need to move towards industrialization and a greater and more ubiquitous role of the State as a way to provide independence from unstable and undynamic traditional commodity exports, found theoretical support in the United Nations Economic Commission for Latin America ("ECLAC") and its import-substituting industrialization ("ISI") development model,⁶ as well as domestic support from certain sectors of local business communities which were somewhat comfortable with expanding the government's efforts to enlarge the industrial base.⁷

⁴ For a brief background on the emergence of SOE in less developed countries in general, see D. Andrew Smith and Micheal J. Trebilcock, *State-owned Enterprises in Less Developed Countries: Privatization and Alternative Reform Strategies*, 12 *European Journal of Law and Economics* 217 (2001), at 218-219.

⁵ For further insights into the short-comings of the export-led growth model in Latin America, and into the causes and effects of international shocks during the first decades of the XX Century, see, generally: Rosemary Thorp, *Progress, Poverty and Exclusion: An Economic History of Latin America in the 20th Century* (IDB, 1998), at 97-125; Victor Bulmer-Thomas, *The Latin American Economies: 1929-1939*, in *Latin America Economy and Society Since 1930* 65 (Leslie Bethell ed., Cambridge University Press, 1998), at 65-114; Victor Bulmer-Thomas, *The Economic History of Latin America Since Independence* (Cambridge University Press, 1994), at 155-193.

⁶ For further insights into the development of ISI policies in Latin America and the role of ECLAC, see, generally: E.V.K. Fitzgerald, *ECLAC and the Theory of Import Substituting Industrialization in Latin America*, in *An Economic History of Twentieth-Century Latin America, Volume 3: Industrialization and the State in Latin America* 58 (Enrique Cardenas et. al., eds., Palgrave, 2000), at 58-97; Thorp, *supra* note 5, at 127-157; Bulmer-Thomas (1994), *supra* note 5, at 276-322.

⁷ See: Thorp, *supra* note 5, at 134-137; Bulmer-Thomas (1994), *supra* note 5, at 350-352.

In a nutshell, the ISI model advanced by ECLAC prescribed deliberate government promotion of inward-looking industrialization, setting up industries to produce goods for local consumption that were previously imported, ensuring the profitability of these industries by shielding them from competing imports through tariffs and other government controls. Industrialization, of course, required significant capital investments (both as finance and technology), something not readily available in the region.⁸

On the financial investment front, typical LAC were characterized by low domestic savings rates and inadequate allocative efficiency in capital markets, lacking the institutions (e.g., stock exchanges and financial intermediaries) required to facilitate their development. In addition to these constraints, private capital investment in LAC usually suffered from other sources of market failure, in particular infrastructure and commercial bottlenecks.⁹ Accordingly, by and large, LAC were caught in low-level investment traps that translated into little or no chance of profitability for investment opportunities that would have been profitable in more developed countries.

ECLAC theorists were aware of the region's "structural rigidities" -a term that encompassed the market imperfections rooted in infrastructural deficiencies and other sources- and of the need of foreign capital flows to ease overcoming these obstacles.¹⁰

In their original conception, such inflows were envisioned mainly coming from public

⁸ See Bulmer-Thomas (1994), *supra* note 5, at 281.

⁹ As Smith and Trebilcock explain, "[i]n an underdeveloped economy, investments are often not successful unless they are coordinated with other investments, e.g., an investment in a manufacturing plant would not be successful without, among other things: the energy and human capital required to operate a plant, a retail sector to sell the manufactured products, transportation to carry the products to retailers, and the infrastructure necessary to facilitate transportation". Smith and Trebilcock, *supra* note 4, at 219.

¹⁰ See Thorp, *supra* note 5, at 133.

foreign money channeled through local governments, mostly from the US.¹¹ Notwithstanding, as new foreign public money began to flow primarily towards Europe and post war reconstruction instead, inward-looking LAC were forced to conceive new sources of investment.¹²

In this context of insufficient capital investment, one of the main motivations that spurred the development of SOE was the need to sustain accelerated industrialization programs embarked by LAC.¹³ Initially, public investment was largely geared towards social infrastructure (e.g., railways, energy, communications), since regulatory pricing policies favoring broad objectives (e.g., low rates for targeted productive sectors and for low-income population) effectively deterred private sector investment in these activities.¹⁴ In time, however, the entrepreneurial role of the State in LAC expanded well beyond the goal of increased capital investments in infrastructure,¹⁵ as SOE began to emerge in “strategic” intermediate goods sectors (e.g., steel),¹⁶ in the financial sector,¹⁷ in branches of industry that resulted to be too sensitive to be controlled by foreign companies (e.g., oil),¹⁸ and in sectors with high-productivity (e.g., mining).¹⁹ The number and size of SOE grew substantially over the coming decades (it is

¹¹ Foreign public money had largely poured into the region during WWII as the US attempted to secure wartime supplies, build alliances and develop new strategic resources. See Thorp, *supra* note 5, at 117-120.

¹² Among other actions, LAC began to revise their stance on foreign direct investment and adopt legislation to attract multinational corporations in certain industrial sectors (e.g., consumer goods manufacturing). See: Enrique Cardenas, José Antonio Ocampo and Rosemary Thorp, Introduction, in *An Economic History of Twentieth-Century Latin America, Volume 3: Industrialization and the State in Latin America 1* (Enrique Cardenas et. al., eds., Palgrave, 2000), at 4-5; Thorp, *supra* note 5, at 133-134; Bulmer-Thomas (1994), *supra* note 5, at 281.

¹³ See Bulmer-Thomas (1994), *supra* note 5, at 282.

¹⁴ See Werner Baer, *Changing Paradigms: Changing Interpretations of the Public Sector in Latin America's Economies*, 88 *Public Choice* 365 (1996), at 366.

¹⁵ See Bulmer-Thomas (1994), *supra* note 5, at 353-358.

¹⁶ Setting up large integrated steel mills was generally considered strategic in order to deepen the industrialization process. See: Baer, *supra* note 14, at 366; Bulmer-Thomas (1994), *supra* note 5, at 355.

¹⁷ Development banks and commercial banks were set up to compensate for the lack of stock exchanges and financial intermediaries required to sustain the industrialization process (e.g., CORFO in Chile and Nacional Financiera in Mexico). See: Baer, *supra* note 14, at 367.

¹⁸ Nationalist concerns generally afforded motivations for creating SOE to exploit non-renewable resources (e.g., YPF in Argentina, Petrobras in Brazil, Pemex in México, PetroPerú in Perú, PDVSA in Venezuela, etc.). See: Baer, *supra* note 14, at 366; Bulmer-Thomas (1994), *supra* note 5, at 355.

¹⁹ See Bulmer-Thomas (1994), *supra* note 5, at 353.

estimated that by the end of the 1970s Brazil had established 654 SOE and that by 1982 Mexico had established 1,115 SOE).²⁰

As the entrepreneurial role of the State expanded throughout Latin America, so did the goals sketched to justify greater intervention, granted though that some SOE were just too hard to justify (e.g., SOE in tourism or nightclubs).²¹ Some justifications were economic in nature, such as the control of inflation, others were influenced by socialist and nationalist ideologies, such as income redistribution, employment generation and sovereign concerns. By and large, a common denominator to this variety of goals was the absence of profitability-based motivations. More often than not, however, such arguments simply concealed political motives pursued by populist and authoritarian governments that sought to secure income from highly productive activities, concentrate power or employ SOE for other self-interested purposes.²²

Despite no shortage of numerous socially profitable investment opportunities, the profitability of SOE in LAC was often limited as a result of financial restraints, price controls, spiraling costs and reinvestment restrictions.²³ Notwithstanding, the inward-development model attached particular importance to the rate of public investment and capital accumulation by the State, which was considered essential for sustaining high rates of private investment (crowding-in effect).²⁴ Accordingly, despite their

²⁰ See: Baer, *supra* note 14, at 367; Bulmer-Thomas (1994), *supra* note 5, at 356.

²¹ See Bulmer-Thomas (1994), *supra* note 5, at 356.

²² See, for example: Paulo Rabello de Castro and Marcio Ronci, Sixty Years of Populism in Brazil, in *The Macroeconomics of Populism in Latin America* 151 (R. Dornbusch and S. Edwards, eds., The University of Chicago Press, 1991), at 157 [explaining the intersection of populism and economics and the use of SOE to promote the centralization of economic power in Brazil under the Vargas administration]; Felipe Larraín and Patricio Meller, The Socialist-Populist Chilean Experience, in *The Macroeconomics of Populism in Latin America* 175 (R. Dornbusch and S. Edwards, eds., The University of Chicago Press, 1991), at 192-194 [explaining the management problems in nationalized industries in Chile under Allende that did not submit to authentic social decisions].

²³ See Bulmer-Thomas (1994), *supra* note 5, at 357-358.

²⁴ See Bulmer-Thomas (1994), *supra* note 5, at 352.

modest contributions to GDP,²⁵ SOE in LAC typically received a particularly disproportionate amount of domestic investment,²⁶ increasing the cost of capital for private enterprises and “crowding-out” socially profitable private investment opportunities,²⁷ a problem that in turn was typically compensated for through the expansion of SOE.²⁸ While the importance of SOE in the process of capital accumulation expanded, contributions of SOE to gross fixed investment tended to exceed its contributions to net output in LAC, and the share of SOE in capital spending resulted far higher in LAC than in other less developed countries (and even higher than in developed countries).²⁹ Moreover, in a context of weak domestic capital markets and limited availability of foreign sources of credit, employing SOE to finance investments and subsidize industrialization implied relying heavily on Governments running current account deficits and later, when inflationary consequences emerged, cutting resources from other social expenditures.³⁰

By the 1960s, the inward-development model wide spread throughout LAC had seemed to reach a dead end. As a result of the model’s inherent contradictions, inward-looking countries were soon characterized by the vicious interaction between balance-of-payments constraints, budget deficits and supply-side bottlenecks, which

²⁵ Excluding Venezuela, average LAC SOE’s contribution to GDP was lower than the average for developing countries and for developed countries. See Bulmer-Thomas (1994), *supra* note 5, at 357.

²⁶ See: Thorp, *supra* note 5, at 161; Bulmer-Thomas (1994), *supra* note 5, at 357.

²⁷ By the late 1970s, the weighted average for LAC share of SOE in gross domestic investment was 29 percent, compared to 7 percent in the U.S., 11 percent in Japan and 17 percent in the U.K. See Bulmer-Thomas (1994), *supra* note 5, at 357 note 120.

In an extreme example, in Venezuela, the participation of public investment in total investment increased from 24 percent in 1970 to 67 percent in 1982, and of the latter figure 81 percent was channeled through non-financial SOE. See Pablo Astorga, *Industrialization in Venezuela, 1936-83: The Problem of Abundance*, in *An Economic History of Twentieth-Century Latin America, Volume 3: Industrialization and the State in Latin America* 205 (Enrique Cardenas et. al., eds., Palgrave, 2000), at 218.

²⁸ See, Bulmer-Thomas (1994), *supra* note 5, at 352-353.

²⁹ Prior to the 1970s, country data (excluding Mexico) reveals that the share of public enterprises in total fixed investment was greatest in Bolivia (reaching 38 percent by 1968); followed by Brazil, Argentina, Chile and Venezuela (reaching 15 percent by the late 1960s); and by Colombia, Panama and Peru (between 6 to 10 percent at its highest levels). See Thorp, *supra* note 5, at 161.

³⁰ See Bulmer-Thomas (1994), *supra* note 5, at 285-287.

translated into exchange-rate instability and inflationary pressures.³¹ A growing consensus regarding the need to implement (unpopular) stabilization policies and a gradual move towards a more outward-looking development model,³² was largely delayed by the unprecedented massive availability of international private lending at negative real interest rates that ensued after the 1973 OPEC oil four-fold price rise.³³

Faced with an over-supply of cheap (unconditioned) foreign funds and encouraged by optimistic commodity price forecasts, most LAC did not hesitate to heavily borrow to sustain new high-levels of public investment to reactivate their growth momentum.³⁴ Large SOE in LAC became the favored clients,³⁵ and the share of SOE in public expenditure typically rose.³⁶ The quality of public spending, however, worsened (e.g., poorly-conceived, excessively capital-intensive projects and insufficient long-term export promotion), as did the quality of management and financial control of SOE (e.g., foreign funding allowed for new possibilities of associated commissions and corruption, resulting in expanded SOE expenditure).³⁷

³¹ In a nutshell, lack of international competition and the small size of the domestic markets, coupled with the ensuing structure of production, dominated by monopolies and oligopolies, had resulted in high unit costs and elevated domestic prices. The model's bias in favor of inward-led growth negatively affected the primary export sector and high production costs of manufactured goods further limited export activities, resulting in rigid dependency upon intermediate and capital goods that still needed to be imported to facilitate industrial activity. On the whole, the terms of trade deteriorated, as the lack of dynamism of the traditional export sector was not compensated by greater industrial exports, thus resulting in constant balance-of-payments difficulties. Furthermore, limited access to domestic and international finance, and the expansive role of the State, had translated into Government deficits, with inflationary consequences. See, generally, Bulmer-Thomas (1994), *supra* note 5, at 283-288.

³² See, generally, Bulmer-Thomas (1994), *supra* note 5, at 323-350.

³³ See, generally: Thorp, *supra* note 5, at 201-216; Ricardo French-Davis, *Latin American Economies: 1950-1990*, in *Latin America Economy and Society Since 1930* 149 (Leslie Bethell ed., Cambridge University Press, 1998), at 171-175; Bulmer-Thomas (1994), *supra* note 5, at 358-365.

³⁴ See Thorp, *supra* note 5, at 209.

³⁵ See Bulmer-Thomas (1994), *supra* note 5, at 358.

³⁶ See Thorp, *supra* note 5, at 209.

³⁷ See Thorp, *supra* note 5, at 207-214.

Increased public expenditure led to mounting government deficits -even in oil producing countries benefited by record prices-,³⁸ which were financed by further borrowing. Between 1975 to 1982, the total public, private and short-term external debt of LAC's rose from US\$ 75.4 billion to US\$ 314.4 billion, while LAC's ratio of service payments to exports increased from 26.6% to 59% in the same period.³⁹

Inevitably, in time, the value of exports began to decline,⁴⁰ resulting in a decrease in lending and deteriorating terms of trade. International capital flows to LAC and SOE were finally halted after the 1982 Mexican moratorium of its external debt. Having been cut-off from their source of deficit financing, by the mid 1980s, SOE were incurring in major losses that imposed heavy burdens on public accounts (e.g., by the second half of the decade, SOE annual losses in Peru amounted to 4.3 percent of GDP, representing 40 percent of total public sector deficit),⁴¹ fuelled inflationary pressures and resulted in extremely poor provisions of services.⁴² The debt crisis set in motion a chain of events that effectively brought an end to the old growth model based on the State's central role in the process of capital accumulation, thus signaling the demise of the entrepreneurial role of the State in Latin America.

II. Theoretical Framework of SOE Failure

2.1 The Property Rights Model

³⁸ See Bulmer-Thomas (1994), *supra* note 5, at 363-364.

³⁹ See Bulmer-Thomas (1994), *supra* note 5, at 363.

⁴⁰ Commodity prices fell as a result of the recession spurred by the strict monetary policies adopted by developed countries after the 1978 oil crisis.

⁴¹ See: Carlos Otero Bonicelli, *Perú: Gestión del Estado en el Período 1990-2000*, Serie Gestión Pública 14 (Instituto Latinoamericano y del Caribe de Planificación Económica y Social - ILPES, 2001), at 17; Rosendo Paliza, *Impacto de las Privatizaciones en Perú*, *Revista Estudios Económicos* 9 (July, 1999), at 18.

⁴² See Sebastian Edwards, *Crisis and Reform in Latin America: From Despair to Hope* (Oxford University Press, 1995) at 173.

Contemporary *theory of the firm* and *public choice theory*, building upon classic *property rights* analysis, give us valuable conceptual insights required to understand the inherent risks associated to State control of entrepreneurial vehicles.

Theory of the Firm

Conventional *theory of the firm* analyses the efficacy of alternative ownership structures -basically owner-controlled private firms and managerially-controlled private firms- in terms of management incentives, monitoring incentives and monitoring abilities.⁴³ The basic line of reasoning is that in a structure in which there is no separation between the management and the ownership of a firm, the owner-manager will make operating decisions which optimize his utility, since all the benefits (efficiency gains) of his decisions will accrue upon him. In turn, in a modern corporation (hereinafter referred to, simply as a “corporation”), in which ownership and management are typically separated, since the efficiency gains will tend to flow to the owners (shareholders) rather than to the managers, the latter have fewer incentives to operate the firm efficiently (or, in other words, may be encouraged to incur in utility-maximizing behaviors in detriment of firm efficiency).

In a *private* corporation, the divergence of shareholders’ and managers’ interests, that translate into reduced managerial incentives to operate efficiently, are somewhat attenuated (but not eliminated) by markets.⁴⁴ For instance, the takeover market (the market for corporate control) and the ensuing risk of raiders obtaining control and

⁴³ See, generally: Henry Hansmann, Ownership of the Firm, 4 *Journal of Law, Economics, & Organization* 267 (1988); Micheal C. Jensen and William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 *Journal of Financial Economics* 305 (1976). For a classic symposium review, see “Corporations and Private Property”, 26 *Journal of Law and Economics* 235 (1983).

⁴⁴ See Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, 1991) at 91.

appointing new management, may deter managerial inefficiency;⁴⁵ the labor market, and its potential to reward proven management skills, may act as incentive for managers to perform; and, competition in product markets may create incentives by threatening managers of inefficient firms with diminished market shares and, at the limit, by punishing inefficient management with ensuing bankruptcy and unemployment.

In addition to market incentives, deficient managerial performance can be counteracted by shareholder action (e.g., positive reinforcement, such as linking compensation to performance or granting stock-option plans that align managers utility more closer to that of the shareholders; or deterrence through punishment, such as managerial replacement),⁴⁶ *provided that* the latter have sufficient incentives to monitor management.⁴⁷ The basic concept is that shareholders will monitor the activities of management so long as the expected returns from monitoring activities exceed the opportunity costs involved (e.g., time and resources spent on monitoring). Typically, this occurs in cases of concentrated ownership (e.g., a majority or controlling shareholder) or when institutional investors are present, in which cases the size and importance of the returns of the investments involved warrant incurring in monitoring activities. Alternatively, in corporations in which ownership is very diffused, corporate governance regulations (e.g., the existence of independent Directors) will tend to compensate for reduced monitoring incentives.

⁴⁵ See, generally: Easterbrook and Fischel, *supra* note 44, at 109-144; Henry G. Maine, *Mergers and the Market for Corporate Control*, 73 *The Journal of Political Economy* 110 (1965).

⁴⁶ See Anne T. Coughlan and Ronald M. Schmidt, *Executive Compensation, Management Turnover, and Firm Performance: An Empirical Investigation*, 7 *Journal of Accounting and Economics* 43 (1985).

⁴⁷ See, generally, Jensen and Meckling, *supra* note 43.

Finally, in order for monitoring activities to be effective, shareholders require to have the abilities to perform this task. In this respect, a central issue is the potential of information asymmetries to hinder a shareholder's ability to monitor management performance. Notwithstanding, in private corporations, diffused ownership has the effect of permitting greater specialization among shareholders (allowing for comparative advantages in ownership), thus facilitating sooner and more accurate responses in the event of inefficient management decisions.⁴⁸ In addition, private corporation are required to periodically disclose information on performance (e.g., independent auditor reports) and stock market prices (and market analysts), albeit not perfect, also provide an index of firm performance which may induce management to perform well to keep share prices high and enable shareholders to fairly quickly adopt corrective actions (e.g., voting "with their feet", selling stock that underperforms).⁴⁹

Public Choice Theory

Public choice theory, somewhat mirroring the theoretical framework reviewed above, takes us one step further to expose the innate problems of publicly or state-owned firms. The debate over whether or not State ownership of firms affects performance can be traced back to Alchian's theoretical prediction that publicly owned firms (SOE) will be inherently less efficient than private firms.⁵⁰ The core of this conjecture rests upon the proposition that "*the differences between public and private ownership arise from the inability of a public owner to sell his share of public ownership*".⁵¹ As De Alessi summarizes, "[s]ince this rules out specialization in their ownership, it inhibits capitalization

⁴⁸ See Louis De Alessi, Private Property and Dispersion of Ownership in Large Corporations, 28 *The Journal of Finance* 839 (1973), at 842-843.

⁴⁹ See Easterbrook and Fischel, *supra* note 44, at 96-97.

⁵⁰ See A.A. Alchian, Some Economics of Property Rights, in *Economic Forces at Work* 127 (Liberty Fund, 1977). [Reproduced from: A.A. Alchian, Some Economics of Property Rights, 30 *IL Politico* 816 (1965).]

⁵¹ Alchian, *supra* note 50, at 138.

of future consequences into current transfer prices and reduces owners' incentives to monitor managerial behavior".⁵² In parallel, conventional public choice theory, modeled around the paradigm of the self-interested bureaucracy,⁵³ predicts that in the context of reduced monitoring activities, SOE managers will maximize their pay, power and prestige in detriment of firm efficiency.

Within this framework, management incentives, monitoring incentives and monitoring abilities discussed above, will typically be less effective in a *public* corporation (SOE) than in a private corporation. Markets, for instance, will tend to be less effective in promoting management performance in public enterprises. Since shares of public corporations can not be sold, SOE are in fact excluded from the market for corporate control (takeovers do not pose a threat);⁵⁴ in contrast to the private sector market for managers, which will likely be driven by efficiency consideration,⁵⁵ managerial appointments in SOE are usually driven by political motivations, hence reducing the labor market's impact on managerial performance;⁵⁶ and since governments seldom permit SOE to go bankrupt (and incur in the political cost of laying-off the SOE workforce), opting instead to subsidize loss-making firms

⁵² Louis De Alessi, *The Economics of Property Rights: A Review of the Evidence*, in 2 *Research in Law and Economics: A Research Annual 1* (R. Zerbe ed., 1980), at 27-28.

⁵³ For a brief overview of conventional public choice theory and its postulates, see Nicholas Mercurio and Steven G. Medema, *Economics and the Law: From Posner to Post-Modernism* (Princeton University Press, 1997), at 85-97.

⁵⁴ As Vining and Boardman explain, "[t]he only way the political market could directly replicate the market for corporate control is by imitating the takeover process, i.e., by threatening privatization." However, this is usually not a credible threat. [Aidan R. Vining and Anthony E. Boardman, *Ownership Versus Competition: Efficiency in Public Enterprise*, 73 *Public Choice* 205 (1992), at 212.]

⁵⁵ See Coughlan and Schmidt, *supra* note 46.

⁵⁶ See: Smith and Trebilcock, *supra* note 4, at 220; Vining and Boardman, *supra* note 54, at 212-213.

given their incentives to use SOE to pursue political goals,⁵⁷ public firm managers have reduced incentives to improve efficiency or avoid unprofitable decisions.⁵⁸

In turn, monitoring incentives in SOE are poor. This predictable result derives directly from Alchian's seminal proposition.⁵⁹ An SOE belongs to the State, therefore, in a sense, it belongs to all citizens collectively but to no citizen in particular. In other words, "ownership" in an SOE is much more diffused than it could ever be even in the largest of private corporations. Moreover, since a citizen cannot sell his participation (e.g., shares) in an SOE, the diminished returns from mismanagement (or, alternatively, the increased efficiency gains from performance enhancing decisions) will not accrue upon any individual citizen in particular but, instead, will be diluted among the collective. Accordingly, as Smith and Trebilcock point out, "*the returns to any one citizen as a result of monitoring [in order to determine the sources of SOE inefficiencies and attempt to correct them] would never be greater than the opportunity cost of the time invested in such activities*".⁶⁰ Furthermore, alternative remedies to overcome this collective-action problem, such as corporate government regulations, will usually be absent, particularly in institutionally weak countries prone to the operation of SOE for political purposes.

Finally, monitoring abilities in SOE are also hindered. This is partially a result of the collective-action problems discussed above: While, admittedly, information available for private corporation monitoring is not perfect, reduced monitoring activities in SOE

⁵⁷ Stiglitz further argues that politicians rarely credibly commit to ending SOE subsidies. [Joseph E. Stiglitz, Some Theoretical Aspects of the Privatization: Applications to Eastern Europe, in *Privatization Processes in Eastern Europe: Theoretical Foundations and Empirical Results* (Mario Baldassarri et. al., eds., Palgrave, 1993), at 179-204.]

⁵⁸ See Smith and Trebilcock, supra note 4, at 220.

⁵⁹ See Alchian, supra note 50.

⁶⁰ See Smith and Trebilcock, supra note 4, at 221.

translate into even scarcer performance information, resulting in greater management discretion and diminishing performance. In addition, as we have seen, since SOE tend to be justified on the grounds of non-productive goals, information disclosed to the public may be non-comparable and of little use to assess firm efficiency.⁶¹

2.2 The Competition Factor

A second source of inefficiency widely cited in the debates surrounding SOE, can be simply recapped as insufficient competition in SOE markets. The current growing consensus is that lack of competition and ownership structures are not mutually exclusive explanations of SOE failure,⁶² but rather are complementary in nature.⁶³

Commonly, government ownership tends to encourage monopolistic markets (or markets dominated by oligopolies). Governments in LAC, for instance, have in the past reserved certain sectors of the economy for SOE, barring private competition or

⁶¹ See Smith and Trebilcock, *supra* note 4, at 221.

⁶² An extreme version of competition argument sustains that competition in product markets, and not whether a firm is publicly or privately owned, is the determinant factor of SOE inefficiency. The policy prescription that would naturally follow would be that introduction of competition in a given SOE market would largely eliminate the need to privatize. However, empirical studies have by and large refuted this hypothesis, evidencing that ownership does in fact matter and that SOE (and even mixed enterprises) perform substantially worse than similar private corporations in competitive environments. See, for example: Eytan Sheshinski and Luis F. López-Calva, *Privatization and Its Benefits: Theory and Evidence*, 49 *CESifo Economic Studies* 429 (2003) [concluding that microeconomic evidence overwhelmingly supports that publicly owned enterprises in competitive environments would not perform better than privately owned companies in the same circumstances in terms of profitability, and may perform worse]; Kathryn L. Dewenter and Paul H. Malatesta, *State-Owned and Privately-Owned Firms: An Empirical Analysis of Profitability, Leverage and Labor Intensity*, 91 *The American Economic Review* 320 (2001) [concluding that government-owned firms are significantly less profitable than privately owned firms, that government firms are less efficient than private firms and that public firms tend to display greater labor intensity than private firms]; Anthony Boardman and Aidan R. Vining, *Ownership and Performance in Competitive Environments: A Comparison of the Performance of Private, Mixed and State-owned Enterprises*, 32 *Journal of Law and Economics* 1 (1989) [concluding that large industrial mixed enterprises and SOE perform substantially worse than similar private corporations; and that mixed enterprises perform better than SOE in terms of sales per employee, perform the same in terms of sales per assets, but often perform no better or worse than SOE in terms of profitability indicators].

⁶³ See, generally: Sheshinski and López-Calva, *supra* note 62; Smith and Trebilcock, *supra* note 4, at 222-223; Dewenter and Malatesta, *supra* note 62; Vining and Boardman, *supra* note 54; John Vickers and George Yarrow, *Economic Perspectives on Privatization*, 5 *Journal of Economic Perspectives* 111 (1991); Boardman and Vining, *supra* note 62.

restricting its freedom to concur by way of massive regulatory legislation.⁶⁴ In sectors of the economy in which private and public corporations concur, governments have a direct stake in protecting SOE, and are prone to subsidize or aid the latter, effectively crowding out the private sector.⁶⁵ In Latin America, as previously discussed, the private sector was also crowded out as a result of the disproportionate amounts of domestic investment geared towards SOE, which increased the cost of capital for private investments.⁶⁶

Absent natural monopoly problems, competition fosters allocative efficiency by reducing a single firm's ability to set prices at marginal cost of production and productive efficiency by encouraging cost reduction. It naturally follows that, absent effective competition, an SOE's pricing and cost practices may tend to reduce social welfare.

The problems derived from monopoly are, of course, not exclusive to SOE.⁶⁷ Absent adequate regulation (e.g., antitrust legislation), private corporations may be motivated to maximize profits in detriment of social welfare. Likewise, certain industries, regardless of whether they are privately owned, are subject to natural monopoly problems (e.g., electricity transmission). Notwithstanding, these situations can be largely compensated by means of regulation. The costs of implementing and enforcing such regulations are not, conversely, sufficient reason to justify state-ownership of

⁶⁴ See Edwards, *supra* note 42, at 173.

⁶⁵ See Smith and Trebilcock, *supra* note 4, at 222.

⁶⁶ *Supra* note 27.

⁶⁷ Granted that, in the heyday of SOE in LAC, insufficient competition was a quandary that plagued both SOE and private corporations (limiting competition was actually a central policy instrument). This fact, however, does not in itself justify the subsistence of SOE, but rather reveals the need to promote competition in both private and public markets.

these industries, given that such an argument would neglect the ownership-related inefficiencies detailed above.⁶⁸

2.3 Evidencing SOE Failure

Empirical studies, both in developed and less developed countries, have by and large confirmed the propositions described above, evidencing that ownership structures do have a significant impact on firm performance (that is, that SOE perform substantially worse than similar private corporations in comparable environments) and that introducing market competition into potentially competitive markets dominated by SOE result in efficiency gains (for both private and public firms).⁶⁹ LAC's experience with SOE, and the most recent and comprehensive empirical studies on the privatizations carried out in Latin America over the past 20 years,⁷⁰ which will be discussed in Section III below, further endorse these conclusions.

How much have SOE cost LAC? The figures are staggering: In Peru alone, it is estimated that between 1968 and 2000, non-financial SOE accumulated losses (at current Dollar value) of approximately US\$29.7 billion, a sum that exceeds by several billion Dollars the amount of investment required to close the country's total infrastructure gap.⁷¹ As of 2005, accumulated losses of Peruvian non-financial SOE are estimated at US\$34.2 billion (an amount that exceeds Peru's current total public

⁶⁸ Smith and Trebilcock, *supra* note 4, at 222.

⁶⁹ See, generally: Sheshinski and López-Calva, *supra* note 62; William L. Meggison and Jeffrey M. Netter, From State to Market: A Survey of Empirical Studies on Privatization, 39 *Journal of Economic Literature*, 321 (2001); Smith and Trebilcock, *supra* note 4; Dewenter and Malatesta, *supra* note 62; Vining and Boardman, *supra* note 54; Vickers and Yarrow, *supra* note 63; Boardman and Vining, *supra* note 62.

⁷⁰ For the most recent and comprehensive data on the results of privatization in LAC, see: Alberto Chong and Florencio López-de-Silanes (Eds.), *Privatization in Latin America: Myths and Reality* (Stanford University Press, 2005).

⁷¹ According to estimates by the *Instituto Peruano de Economía*, Peru's total infrastructure gap in transport (roads, airports, ports and rail), water and sanitation, energy and telecommunications is roughly US\$24 billion.

external debt by 53%).⁷² Apart from financial losses and the general welfare consequences of reduced firm efficiency, poor SOE performance, of course, entails derivative social costs that should not be readily ignored. In LAC, for instance, the structures of production fostered by SOE, characterized by monopolies and oligopolies, along with other sources inefficiencies derived from inward-looking development policies, translated into high unit costs of production which negatively impacted the possibility of exporting manufacturing goods, deteriorating terms of trade and, ultimately, contributing to the balance-of-payments difficulties and exchange-rate instability that constantly troubled LAC during most of the latter half of the past century.⁷³ In turn, in a context of reduced availability of capital, employing SOE to finance investments and subsidize industrialization implied relying heavily on Governments running current account deficits (with the inflationary consequences that are all too familiar to Latin Americans) and later, in light of emerging disequilibria, cutting resources from other useful social expenditures.⁷⁴ Likewise, as previously discussed, despite their modest contributions to GDP, SOE in LAC typically received a particularly disproportionate amount of domestic investment,⁷⁵ increasing the cost of capital for private enterprises (crowding-out the private sector) and diverting resources from sectors of the economy in which they could be more productively employed.⁷⁶ Sources estimate that the direct and indirect losses attributable to poor SOE performance in a typical less developed country range from 5 to 8 percent of GDP and as high as 8 to 12 percent of GDP in less developed countries with a relatively large SOE sector.⁷⁷

⁷² Estimates by the *Instituto Peruano de Economía*.

⁷³ See Bulmer-Thomas (1994), *supra* note 5, at 283-285.

⁷⁴ See Bulmer-Thomas (1994), *supra* note 5, at 285-287.

⁷⁵ See: Thorp, *supra* note 5, at 161; Bulmer-Thomas (1994), *supra* note 5, at 357.

⁷⁶ See, Bulmer-Thomas (1994), *supra* note 5, at 352.

⁷⁷ See Smith and Trebilcock, *supra* note 4, at 226, citing data from Russel Muir and Joseph P. Saba, *Improving State Enterprise Performance: The Role of Internal and External Incentives* (World Bank, 1995).

In all fairness, any assessment of the social costs that SOE may have represented to LAC would be biased if we did not try to account for the putative benefits (the potential positive social externalities) derived from the non-profitable goals SOE allegedly pursued. Notwithstanding, despite the scarcity of relevant data, it seems quite apparent that SOE in LAC have, on a whole, not accomplished the goals they allegedly pursued, nor delivered the social benefits they were meant to achieve.

The most often cited goal to justify the creation of SOE in LAC is increased capital investment in infrastructure. The fact that, despite several improvement in basic infrastructure, by the 1980s most LAC were still caught in low-level investment traps, simply reveals the lack of success in developing and extending infrastructure through SOE.⁷⁸

LAC SOE's record in achieving non-productive goals (mainly income distribution, employment generation and the control of inflation) is not much better. Most disturbingly, the existing data reveals that from the period between 1950 and 1990, income distribution, measured both in terms of the share of income received by the bottom quintile of the population and by Gini coefficient, actually worsened throughout Latin America.⁷⁹ The generation of employment opportunities was one of the biggest disappointments of inward-industrialization, centered around capital

⁷⁸ Comparative empirical data seems to hold true this conclusion in other less developed countries. See Smith and Trebilcock, *supra* note 4, at 226.

⁷⁹ After World War II, while other regions of the world experienced improvements in the share of income received by the bottom quintile of the population, LAC witness further declines (by 1970, the average for Latin America was 3.4% compared to 4.9% in all developing countries). See, Bulmer Thomas (1994), *supra* note 5, at 313.

In terms of Gini coefficient (a rising Gini coefficient over time reflecting a worsening income distribution) existing data supports increases from 0.37 in Argentina in the early 1950s to 0.52 in 1990, from 0.57 in Brazil in 1960 to 0.63 in 1990, from 0.44 in Chile in the early 1950s to 0.52 in 1978. Improvements are found in Mexico (from 0.61 in 1963 to 0.52 in 1989) and Colombia (from 0.51 in the early 1950s to 0.47 in 1988). See Thorp, *supra* note 5, at 352.

intensive activities that determined that the rate of growth of industrial production be much greater than the growth rate of employment in industry, which in turn, in light of a high rate of urbanization, incited the development of a massively underemployed urban informal sector.⁸⁰ In respect to controlling inflation, it is not necessary to go into further details in light of the well-known consequences of expansive monetary policies to finance deficits and macroeconomic mismanagement that plagued Latin America during this time.⁸¹

Finally, we cannot conclude this section without alluding to sovereign-related concerns that are often voiced to justify the state's entrepreneurial role in Latin America. Without going into the philosophical merits, or lack thereof, of nationalistic ideologies, one can concede that public ownership may play to a society's benefit when national security issues are at stake. However, it is disputable that sovereignty alone, a concept all too frequently invoked in the region, may serve to justify the State's control of SOE to exploit non-renewable resources (or other industries) that serve no useful national security purposes, particularly in light of the track record of poor SOE performance in LAC.⁸² Latin American political history reveals that, more often than not, such arguments simply conceal political motives pursued by populist and authoritarian governments that seek to secure income from highly productive activities, concentrate power or employ SOE for other welfare reducing self-interested purposes.⁸³ In countries battered by insufficient growth rates, income inequality and extreme poverty rates, supporting inefficient industries operated through SOE in

⁸⁰ See: Benedict J. Clements, *State Enterprises and Employment Generation in Brazil*, 41 *Economic Development and Cultural Change* 51 (1992) [concluding with empirical data that SOE in Brazil resulted inferior to the private sector in generating jobs for the urban workforce]; Werner Baer, *Industrialization in Latin America: Successes and Failures*, 15 *The Journal of Economic Education*, 124 (1984), at 128-129.

⁸¹ See, generally, Rudiger Dornbusch and Sebastian Edwards (Eds.), *The Macroeconomics of Populism in Latin America* (University of Chicago Press, 1991).

⁸² See Bulmer-Thomas (1994), *supra* note 5, at 353-355.

⁸³ *Supra* note 22.

circumstances in which the potential social benefits are ambiguous, only diverts resources away from socially profitable investment and expenditure opportunities.

III. The Success and Shortcomings of Latin American SOE Divestiture

Mexico's 1982 default on its international debt brought to a halt the massive flows of private commercial lending to Latin America that, coupled with soaring interest rates, a steady weakening of international commodity prices, and debt servicing that impinged heavily on national budgets, resulted in severe balance of payments and fiscal crisis.⁸⁴ The gravity of the crisis afforded momentum to the adoption throughout the region of a more comprehensive version of the traditional orthodox monetarist approach to stabilization that had been widely advocated by the international monetary community since the late 1950s, that was coupled with structural reform prescriptions (in time, these policies were to be known as the "Washington Consensus").⁸⁵ Having proven their effectiveness at reducing budget deficits, reducing disequilibria and controlling inflation after the Bolivian hyperinflation crisis of 1985, even the more reluctant LAC, that had opted to experiment with heterodox micromanagement policies that only worsen their crisis (e.g., Argentina, Brazil and Peru),⁸⁶ followed suit.

⁸⁴ See: Thorp, *supra* note 5, at 217-218; Bulmer-Thomas (1994), *supra* note 5, at 366-369.

⁸⁵ See, generally, John Williamson (Ed.), *Latin American Adjustment: How Much Has Happened?* (Institute for International Economics, 1990).

⁸⁶ Although the implementation and management of heterodox policies in Argentina, Brazil and Peru varied somewhat, it is nonetheless possible to identify several common features. These experiments combined elements of traditional orthodox stabilization (for example, devaluation and price adjustments) with unorthodox elements designed to curtail inflationary expectations (for example, price, salary and exchange-rate freezes) and increase real tax revenue. For further information on heterodox policies, see: Thorp, *supra* note 5, at 224-225; Edwards, *supra* note 42, at 33-39; John Crabtree, *Peru Under García: An Opportunity Lost* (Macmillan, 1992); Ricardo Lago, *The Illusion of Pursuing Redistribution Through Macropolicy: Peru's Heterodox Experience 1985-1990*, in *The Macroeconomics of Populism in Latin America* 263 (R. Dornbusch and S. Edwards, eds., The University of Chicago Press, 1991).

The first generation Washington Consensus policies addressed the deeply rooted inherent deficiencies of the economic structures inherited from past State-led and debt-led growth, resulting from the protective nature of its policies and the excessive role of the State, emphasizing the need to reform balance-of-payment policies (e.g., real exchange rates, trade liberalization and openness towards direct foreign investment), adopt strict fiscal policies (e.g., fiscal discipline and priority setting, tax reform), liberalize finance (e.g., capital markets) and promote a competitive environment (e.g., deregulation, property rights).⁸⁷ In this context, SOE divestiture was seen as an essential all-purpose public policy -a way to overhaul the economic structures derived from the State's ubiquitous role in economic activities, increase State revenues, reduce deficits from failing public firms, balance budgets, improve the efficiency and quality of public services, promote competition and attract foreign investment.⁸⁸ Accordingly, throughout the 1990s, massive privatization programs were launched in most LAC,⁸⁹ the results of which are discussed below.

3.1 The Economic Results of Latin American Divestiture

It almost goes without saying that the implementation of privatization programs and other structural reform policies in Latin America have contributed to overcome the sources of macroeconomic instability that detonated the debt crisis of the 1980s.

⁸⁷ See Thorp, *supra* note 5, at 226-231.

⁸⁸ See Edwards, *supra* note 42, at 174.

⁸⁹ In this paper, the term "divestiture" is used to refer to all forms of disposition or disposal of an SOE, including privatization, liquidation or other means; and the term "privatization" is used to refer to all forms of transferring SOE to the private sector, including the transfer of ownership, sale of productive assets, temporary transfers through concessions, etc.

Notwithstanding, skepticism concerning the microeconomic effects of privatization in Latin America still persists.⁹⁰

Individual cases of successful and botched privatizations in Latin America can be readily identified. Nevertheless, it would be misleading to draw general conclusions concerning the benefits (or lack thereof) of divestiture from such random examples, for we would be incurring in a sample selection bias. Much of the existing literature on firm performance after privatization in Latin America suffers from this and other sources of sample selection bias,⁹¹ or is otherwise flawed due to the use of non-comparable data (e.g., meaningful comparisons between pre and post-privatization performance cannot be drawn when SOE are split-off prior to privatization or are merged after changes in ownership).⁹²

The most comprehensive studies on the performance of privatized SOE in the seven leading Latin American privatizing countries,⁹³ conducted by a research-network supervised by Alberto Chong and Florencio López-de-Silanes, have recently been published and their results are outlined below. To overcome the obstacles detailed in the preceding paragraph, the researchers performed a painstakingly detailed collection of data, compiling extensive pre and post-privatization information for nearly complete cross-industry samples of privatized firms of all sizes, as well as

⁹⁰ See, for example: David McKenzie and Dilip Mookherjee, *The Distributive Impact of Privatization in Latin America: Evidence from Four Countries*, 3 *Economía* 161 (2003); K. Bayllis, *Privatization and Poverty: The Distributional Impact of Utility Privatization*, 73 *Annals of Public and Cooperative Economics* 603 (2002); Nancy Birdsall and John Nellis, *Winners and Losers: Assessing the Distributional Impact of Privatization*, Working Paper Number 6 (Center for Global Development, 2002).

⁹¹ See Alberto Chong and Florencio López-de-Silanes, *The Truth About Privatization in Latin America*, in *Privatization in Latin America: Myths and Reality 1* (A. Chong and F. López-de-Silanes, eds., Stanford University Press, 2005), at 9-12.

⁹² See Chong and López-de-Silanes, *supra* note 91, at 17-18.

⁹³ Argentina, Bolivia, Brazil, Chile, Colombia, Mexico and Peru.

detailed firm or plant-level audited accounting information, proxy financial information and other sources of information that allowed data aggregation.⁹⁴

Diverging from a growing trend in public perception throughout the region, the studies compiled by Chong and López-de-Silanes indicate that the privatization of SOE carried out in the countries surveyed during the past two decades, has led to increased profitability resulting from improved operating efficiency supported by accelerated restructuring and productivity improvements (e.g., reductions in unit costs and increased output),⁹⁵ and not at the expense of government revenues or from labor and consumer exploitation. On the contrary, these studies consistently point to increased tax revenues from privatized SOE.⁹⁶ Likewise, these studies reveal important increases in real and industry-adjusted wages (between 70 to 110 percent) and immaterial median savings from reduced labor costs, thus refuting the hypothesis that a large source of productivity gains in privatized SOE is to be found in transfers from workers to private shareholders (e.g., resulting from fewer workers and lower wages).⁹⁷ Finally, these country surveys bring to light that privatization of SOE have generally resulted in improved product and service quality (although much can still be done to improve access and distribution of public services and utilities),⁹⁸ and that the median change in profitability of privatized firms in potentially noncompetitive industries is generally lower than that of privatized firms in competitive industries

⁹⁴ See Chong and López-de-Silanes, *supra* note 91, at 6-18.

⁹⁵ According to these studies, the median decline of cost per unit of privatized SOE in the countries surveyed fell 16 percent, the median country sales-to asset ratio increased 16 percent, the median country workforce reduction was 24 percent and, despite modest investment and falling employment, the median firm output increased over 40 percent. Improvements in privatized SOE generally outpaced matching private firms, ruling out that gains could be attributed to changes in macroeconomic conditions, and the performance gap between privatized SOE and comparable private firms was significantly reduced. See Chong and López-de-Silanes, *supra* note 91, at 18-26.

⁹⁶ See Chong and López-de-Silanes, *supra* note 91, at 27-28.

⁹⁷ See Chong and López-de-Silanes, *supra* note 91, at 28-32.

⁹⁸ See Máximo Torero and Alberto Pascó-Font, *El Impacto Social de la Privatización y Regulación de los Servicios Públicos en el Perú*, Documento de Trabajo N° 5 (Grade, 2000).

(while the growth in investment, employment and output in the former have exceeded the growth achieved in the latter), hence casting a serious shadow of doubt over the often voiced proposition that post-privatization firm profitability may be a result of market power and consumer exploitation.⁹⁹

By and large, the empirical evidence outlined above confirms that changes in ownership structures implemented throughout Latin America over the past two decades have had a significant positive impact upon firm performance and social welfare. Individual instances of privatization failure, of course, can still be identified, although the aggregate data tends to reveal that the magnitude and severity of such failure does not necessarily coincide with the perceptions that fuel certain sectors of contemporary Latin American public opinion. The potential and actual sources of SOE privatization failure are delineated in the following section.

3.2 Potential and Actual Sources of Divestiture Failure in Latin America

For all its technical and economic explanations and achievements, privatization is also fundamentally a political process.¹⁰⁰ As such, we cannot understate the fact that the effects of privatization may be underscored by the political economy in which it is carried out. Likewise, we cannot lose sight of the fact that privatization does not end the State's involvement in the economy, but rather transforms it away from the role of directly producing goods and services toward the role of supervisor and regulator of the privatized companies in a competitive environment, a sometimes uncomfortable

⁹⁹ See Chong and López-de-Silanes, *supra* note 91, at 32-39.

¹⁰⁰ See: W. Rand Smith, *Privatization in Latin America: How Did It Work And What Difference Did It Make?*, 44 *Latin American Politics and Society* 153 (2002), at 155; William Megginson, *Privatization*, 118 *Foreign Policy* 14 (2000), at 14; Luigi Manzetti, *Privatization South American Style* (Oxford University Press, 1999), at 1-3.

transition that if not adequately implemented may have bearing upon the potential results of market reforms.

Political Economy Issues

As previously discussed, the policy of privatization emerged in LAC in the midst of, arguably, the region's most acute economic crisis since independence. The scope and severity of the crisis afforded an internal mood that favored the adoption of privatization programs and weakened resistance by certain domestic socioeconomic interest groups (e.g., military, organized labor). External conditions, such as the availability of international investors interested in expanding operations into the region, foreign aid and multilateral technical assistance, were also encouraging, contributing to consolidate the opportunity to initiate the reforms.

Privatization, of course, requires more than just a favorable environment. As Manzetti explains, the adoption of this type of reform policy requires the convergence of both opportunity *and* leadership willingness.¹⁰¹ The Chilean privatization process illustrates this point. In Chile, the opportunity to embark in economic liberalization and privatization presented itself roughly 15 years ahead of other LAC, following the 1973 military coup. While most firms that has been nationalized between 1970 and 1973 were returned to their original owners by mid-decade and a significant part of the SOE that existed prior to 1970 had been privatized by 1980, the military government did not have the will to loose control over the copper, oil exploration and steel industry, as well as over the largest electricity and utilities companies, alleging national security and strategic reasons (in fact, in 1974 the military actually acquired controlling interest

¹⁰¹ See Manzetti, *supra* note 100, at 294-296.

over the main telephone company).¹⁰² It was only until after the 1981-1983 financial crisis that the military were persuaded by its team of ideologically motivated policy-makers to privatize steel, public utilities, the national airline and other large SOE, but even then the government refused to sell its interests in copper mining (CODELCO) and oil (ENAP) (by 1989, only 19 pre-Allende SOE were still held by the State).¹⁰³

The willingness to pursue reforms, on the other hand, is often not necessarily motivated by ideological conviction. In many cases, leadership willingness is driven by pragmatism and self-interested personal or political goals that have the potential to directly affect the implementation and results of the policies pursued. For instance, the review of contemporary political economy studies on the implementation of privatization and other reform policies carried out in Latin America during the 1990s, reveals that potential instances of implementation failure (e.g., inadequate contract drafting, undervaluation, etc.) are more likely to occur (or, at least, to be perceived to have occurred) in the presence of strong centralized leadership fuelled by personal or political motivations, or in a context of policymaker-capture by interest groups that may result in policy-bias. The Peruvian, Argentine and Mexican experiences, in this respect, are most telling.

In hindsight, analysts concur that during his decade in power, Peruvian President Alberto Fujimori followed the populist path that has long been a trait of Peruvian politics,¹⁰⁴ emerging during the 1990s as the personification of political power,

¹⁰² See: Ronald Fischer, Rodrigo Gutiérrez and Pablo Serra, *The Effects of Privatization on Firms: The Chilean Case*, in *Privatization in Latin America: Myths and Reality 197* (A. Chong and F. López-de-Silanes, eds., Stanford University Press, 2005), at 206-213; Judith A. Teichman, *The Politics Of Freeing Markets In Latin America: Chile, Argentina And Mexico* (The University of North Carolina Press, 2001), at 73-76.

¹⁰³ See Fischer, Gutiérrez and Serra, *supra* note 102, at 197-198, 207-211; Teichman, *supra* note 102, at 77-83.

¹⁰⁴ See, generally, John Crabtree, *Neo-Populism and the Fujimori Phenomenon*, in *Fujimori's Peru: The Political Economy 7* (J. Crabtree and J. Thomas, eds., Institute of Latin American Studies, 1998).

reaffirming the Executive Branch's hegemony over the rest of the State and often using the resources at his disposal to build-up his own personal standing with the electorate.¹⁰⁵ Analysts have observed that the implementation of reform policies under Fujimori stemmed from a combination of economic pragmatism and political populism (a need to quickly get control over the economic crisis inherited from heterodoxy and consolidate personal power), a combination that is crucial for understanding institutions that developed and withered under the Fujimori regime.¹⁰⁶ As a result, the privatization program pursued by the Fujimori Administration became a means to rapidly attract foreign investment, raise State revenues and diminish the power of potential political enemies (namely, the unions).¹⁰⁷ Not surprisingly, within this environment, it is not unusual to find allegations of inaccurate valuations, lack of transparency, inconsistent rules and insufficient oversight in the privatization processes implemented,¹⁰⁸ or cases in which short-term fiscal revenue motivations seem to have been prioritized over long-term efficiency goals pursued by SOE divestiture.

¹⁰⁵ See Crabtree, *supra* note 104, at 17-19.

¹⁰⁶ At the beginning of the Fujimori administration, Peru's economy was suffering from stagflation, with a monthly inflation rate of around 30% and an official negative GDP growth of 11,6% in 1989. In turn, the new government's legitimacy was weak and fragile, having been elected in part as a result of unprecedented tactical voting, lacking a political party to support it and having only a minority in the Congress. [See, generally, Crabtree, *supra* note 104, at 17-19. See, also: Smith, *supra* note 100, at 158; Manzetti, *supra* note 100, at 235-236.] Thus, from the start, the Fujimori Administration rushed to consolidate and sustain public support by restoring both the economic and social order absent during a great part of the previous decade. From this perspective, Fujimori's economic policies, and his embrace of privatization, were not a result of his personal ideological preferences, but rather a pragmatic political decision. [See Manzetti, *supra* note 100, at 246-247.] He had no time to spare testing heterodox formulas. Confronted with an urgent need of financial resources, international reserves having been depleted by the previous Administration, and quick economic results to booster support, the Washington Consensus policy instruments were the natural, if not the only, choice. The increase in social spending, designed to make the 'Fujishock' politically viable, and the speed with which the policies began to yield results, helped ease public unrest. [See: Adolfo Figueroa, *Income Distribution and Poverty in Peru*, in *Fujimori's Peru: The Political Economy* 127 (J. Crabtree and J. Thomas, eds., Institute of Latin American Studies, 1998), at 146-147; Manzetti, *supra* note 100, at 235.] As hyperinflation was controlled and economic growth picked up, so too did Fujimori's popularity and personal power, a correlation he was well aware of. Thus, as long as the economic program adopted showed results, he would be unwilling to tamper with its prescriptions. This pacific coexistence between political populism and pragmatic economic liberalism is crucial for understanding institutions that developed and withered under the Fujimori regime.

¹⁰⁷ See: Smith, *supra* note 100, at 158; Manzetti, *supra* note 100, at 283-288.

¹⁰⁸ See Smith, *supra* note 100, at 158.

The adoption of privatization as a policy instrument in Argentina parallels the Peruvian experience in many ways.¹⁰⁹ Commentators observe that Menem's implementation of the stabilization and structural reform policies that led to embrace privatization, also stemmed from a combination of the need to quickly get control over the economic crisis and to consolidate personal standing. In Menem's case, in addition to pursuing the goal of achieving rapid economic results, analysts observe that these policy instruments were strategically employed to recast the Peronist Party in his image, employing the privatization process as a means to build new alliances with domestic capital and conservative leadership, weaken the Peronist union structure and consolidate personal power.¹¹⁰ As a result, privatization is said to have been highly discretionary and lacking mechanism of accountability, resulting in kickbacks, corruption, bid-rigging and leaks of privileged information.¹¹¹ The harsh hard-line perception of privatization under Menem is summarized as follows: *"...Menem's program (...) was marked by favoritism, authoritarianism and corruption. Specifically, Menem's haste, coupled with the tilt toward big business (while labor was either coopted or repressed), fostered an ethos of executive privilege and cronyism that ultimately undermined both the political legitimacy and economic efficiency of the privatization. (...) In effect, the conglomerates supplied campaign funds and other kickbacks to Menem and his circle, and the president returned the favor by arranging sales of SOEs to these conglomerates on generous terms, including low selling prices and large tax breaks"*.¹¹²

¹⁰⁹ In 1989, the Menem Administration inherited a similar bankrupt government and an economy suffering from stagflation, without a strong popular mandate to pursue economic reform policies.

¹¹⁰ See: Smith, *supra* note 100, at 156; Teichman, *supra* note 102, at 114-118, 127; Manzetti, *supra* note 100, at 77-78.

¹¹¹ See Teichman, *supra* note 102, at 116-117; Roberto Saba and Luigi Manzetti, *Privatization in Argentina: The Implications for Corruption*, 25 *Crime, Law and Social Change* 353 (1996).

¹¹² Smith, *supra* note 100, at 156-157.

In the Mexican case, while it is not apparent that the government's privatization program was motivated by a need to build alliances, analysts argue that under the Salinas Administration (1989-1993), in which 96 percent of all state-owned assets were privatized,¹¹³ *"a small group of powerful entrepreneurs enjoyed easy access to key members of the policy core, and close personal relationships developed from these interactions"*.¹¹⁴ This privileged access to policy-makers is said to have translated into benefits for the owners of powerful conglomerates.¹¹⁵ Moreover, the highly discretionary fashion in which some Mexican state-owned utilities, highways and banks were privatized, contributed to fuel allegations of cronyism and direct benefits to the country's political elite by way of front men.¹¹⁶

In contrast to the experiences outlined above, Brazil's privatization process under Fernando Henrique Cardoso is often cited as a rather exemplary process. Observers consider that in Cardoso's case, the willingness to push forward the privatization process stemmed from an ideological commitment to market reforms (a somewhat ironic turn of events, since Cardoso had been a fervent defender of ISI policies in his youth).¹¹⁷ Cardoso was also largely reputed to be a very skillful politician, who was able to push privatization forward through effective communication, dialogue and inclusive consensus building with Congress, state governments and interest groups.¹¹⁸ It is interesting to note that allegations of undervaluation and other implementation flaws are often restricted to privatizations implemented by Cardoso's predecessors.¹¹⁹

¹¹³ See Alberto Chong and Florencio López-de-Silanes, Privatization in Mexico, in Privatization in Latin America: Myths and Reality 349 (A. Chong and F. López-de-Silanes, eds., Stanford University Press, 2005), at 354.

¹¹⁴ Teichman, supra note 102, at 145.

¹¹⁵ See Teichman, supra note 102, at 146.

¹¹⁶ See Teichman, supra note 102, at 147.

¹¹⁷ See Smith, supra note 100, at 157.

¹¹⁸ See Smith, supra note 100, at 157.

¹¹⁹ The Brazilian privatization process before Cardoso is somewhat similar to the Peruvian and Argentinean cases described above. In 1990, upon taking office, Fernando Collor de Mello, similarly confronted with an

Oversight Issues

Structural reform policies and SOE divestiture entail a profound transformation of the State's role in economic activities -from protagonist to overseer. To be sure, this transition is sluggish, costly and technically challenging, for it requires that institutionally weak States with systematic failing bureaucracies move from managing individual SOE that for decades were run with scarce oversight to supervising and regulating entire sectors of industry in unfamiliar competitive environments.¹²⁰

Few would dispute that making restructured and privatized markets work requires implementing sound horizontal regulation (e.g., financial and corporate governance regulation) and industry-specific regulation, competition policies, and the establishment of clear property rights, as well as parallel institutional reforms. Effective and enforceable antitrust legislation, for instance, tends to mitigate the risk of market power translating into consumer welfare losses and corporate governance regulation facilitates the access to, and the efficient allocation of, capital required to finance investments. Absent an effective regulatory framework and capable regulators, many of the intended benefits of privatization may go largely unrealized, at least in the short-term, particularly in sectors subject to natural monopoly problems or

economic crisis inherited from heterodoxy and a divided Congress, executed a swift stabilization program and pushed for structural reform and privatization. [See Manzetti, *supra* note 100, at 151-153.] However, unlike Fujimori and Menem, Collor's actions stirred up a backlash from Congress, labor, university students, and even the Catholic Church, fearing that Collor was using the privatizations to build up his political power. [See: Smith, *supra* note 100, at 157; Manzetti, *supra* note 100, at 153.] After only two years in office, Collor was removed by Congress in midst of corruption allegations, being succeeded by Itamar Franco, a caretaker President lacking a power base of his own, who slowed down the pace of reforms, being able to execute only a handful of privatizations (between the two, only 34 SOE were divested). [See: Smith, *supra* note 100, at 157; Manzetti, *supra* note 100, at 153-157.]

¹²⁰ See William Megginson, *Privatization*, 118 *Foreign Policy* 14 (2000), at 22.

constrained by limited competition in which efficiency gains from ownership change may not be fully achieved.¹²¹

Regulation and institutions, however, cannot be put into place overnight. Regulatory policy-making effectiveness is conditioned by the industry structure pursued, as well as by technical knowledge, abilities and experience that are developed over time through training and learning-by-doing. In turn, institution building and the development of institutional capacities is largely a result of agency design and planning, resourceful leadership and management, check-and-balance controls and political backing resulting in effective budgetary, technical and decision-making autonomy, factors that, over time, determine institutional consolidation. Consequently, successful regulatory drafting and institutional reform are naturally long and imperfect processes, a fact that in itself has the potential to delay or limit the realization of benefits pursued by divestiture.

Moreover, regulatory and institutional reform may further be hindered as a result of the peculiarities of the political environment in which they are implemented. For instance, within the context of the political economy under which divestiture was implemented in the LAC described above, analysts argue that in Argentina, market reforms were not coupled with a clear regulatory framework and effective antitrust legislation allowing for possible restrictive practices and abuses of dominant position by utilities that were privatized under monopolistic conditions.¹²² Furthermore, it is argued that, in Argentina, the institutional vacuum under which privatizations were

¹²¹ See Luigi Manzetti, *Political Economy of Regulatory Policy*, in *Regulatory Policy in Latin America: Post Privatization Realities* 83 (L. Manzetti, ed., North-South Center Press, 2000).

¹²² See, for instance, Roberto Saba, *Regulatory Policy in an Unstable Legal Environment: The Case of Argentina*, in *Regulatory Policy in Latin America: Post Privatization Realities* 257 (L. Manzetti, ed., North-South Center Press, 2000).

carried out (e.g., abusing urgency decrees), the political goals pursued by such processes (e.g., reward supporters) and the corruption that surrounded their implementation, contributed to fostering weak regulatory structures, insufficient funding of regulatory institutions and political intervention in the regulators decision-making processes (in some cases, it was actually a deliberate action to lure investors).¹²³ Similar allegations of weak or insufficient oversight have been made in regards to the privatizations carried out in most LAC.¹²⁴

¹²³ See Manzetti, *supra* note 100, at 328.

¹²⁴ See: Chong and López-de-Silanes, *supra* note 91, at 52-55; Manzetti, *supra* note 100, at 318-321, 328.

IV. Globalization and its Discontents: The Pending Agenda

In June of 2002, a massive protest broke-out in Arequipa, Peru's second largest city, in response to the government's plan to privatize two local state-owned energy-generating companies (Egasa and Egesur). According to the New York Times, the protesters included from *"Marxists shouting 60's-era slogans, and hard-bitten unionists (...to) Fanny Puntaca, 64, a shopkeeper and grandmother of six"*.¹²⁵ Despite President Toledo's announcement that the privatization would continue regardless of opposition, violent and destructive rioting and looting eventually led the government to suspend the sale. Just a few weeks later, while anti-globalization campaigners were still heralding the result as signaling the death of privatization, the government announced it had closed a US\$261 million deal, auctioning a 30-year concession right to a private consortium to operate the state-owned electricity transmission enterprises Etecen and Etesur, also located in Arequipa. The day after the concession was granted, labor representatives of the privatized SOE issued a press release announcing that they agreed with the concession, stating that their labor rights had been adequately protected and asking third parties not to intervene on their behalf or protest against the concession. Explaining the somewhat unexpected success of the latter privatization, the winning consortium's counsel acknowledged that his team was aware of the need to avoid the problems of the Egasa-Egesur deal and stated the following:

"One of the main difficulties of the deal was negotiating with the workers. We had to tell people about the benefits that [private operators] will bring, such as a 10 per cent cut in the transmission tariff and the interconnection of the supplies of Peru, Ecuador and Bolivia, which will allow Peru to export energy to the entire Andean community. (...) This is the first deal to be announced jointly by government ministers and labour representatives.

¹²⁵ Juan Forero, Still Poor, Latin Americans Protest Push for Open Markets, New York Times (July 19, 2002), at A1.

There was no opposition to concession among the workers -in fact they were keen to point out its benefits. We believe that if the process is communicated to the workforce, and they agree with it, everything runs more smoothly for everybody".¹²⁶

The example outlined above reveals that opinion trends against privatization in certain quarters of Latin American society are not necessarily rooted in an ownership issue, but rather in the political economy and oversight shortcomings previously discussed. These shortcomings, however, do not invalidate the theoretical premises and empirical evidence upon which privatization of SOE stands. Conversely, they do indicate the paramount importance of introducing policies to foster greater transparency and political accountability into the divestiture processes and to strengthen the regulatory and institutional framework under which privatized firms must endure.

Smith and Trebilcock argue that alternative implementation methods, such as contracting out and management performance contracts, may be more appropriate in the context of institutionally weak democracies battered by unstable political environments, corruption and insufficient competition.¹²⁷ The current movement observed in Latin America towards alternative privatization schemes, such as public-private partnerships, is partially a response to this point of view. Notwithstanding, regardless of how we label or package it, any attempt to deepen privatization efforts and consolidate its benefits, cannot be conceived and executed in a political vacuum. On the contrary, it will necessarily require greater civil community involvement and citizen oversight schemes, effective communication, profit-sharing, inclusive dialogue and consensus building with labor and other interest groups, issues all too often neglected in the region.

¹²⁶ Peruvian Privatisation Runs Protest Gauntlet, 1 Latin Lawyer Magazine (October/November 2002).

¹²⁷ See Smith and Trebilcock, supra note 4, at 238-244.

Support for structural reform policies in general, usually follows a “J” curve, initially declining and later recovering upon policy maturity.¹²⁸ If popular support of privatization in many LAC is currently at the low point of this curve, retreating at this stage would simply be a self-defeating purpose.

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¹²⁸ See Chong and López-de-Silanes, *supra* note 91, at 1.