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Ideas for

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Development

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in the Americas

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Nationalization for the Poor?



Inter-American Development Bank
Research Department

Privatization has a bad name in Latin America and some leaders have decided to change gears and expand State control. However, nationalization of key sectors, executed in the name of the lower and middle classes, is likely to backfire and result in poorer services delivered by unprofitable companies to fewer people. The charge that privatization benefits rich investors and company shareholders at the expense of poor consumers is simply not true. Governments that operate under that assumption may find they are hurting the citizens they profess to protect.

During the 1990s, Latin America led the developing world in a privatization process concentrated mainly in the public service and infrastructure sectors. Control of state companies in telecommunications, electricity, fuel, water and other areas was transferred to the private sector in a quest for greater efficiency. In most cases, the objective was achieved and the data show that after nearly two decades, privatization considerably improved the profitability and efficiency of the affected companies.

So why do two out of every three Latin Americans say privatization has been bad for them and their countries? The answer probably lies in the cloud of corruption that has overcast some of the more notorious privatization cases or the scandalous enrichment of a few individuals or companies involved. Job losses are also to blame, as some workers are necessarily displaced when economic, rather than political, criteria are used in making employment and investment decisions.

Contrary to popular belief, privatizations can be socially very beneficial thanks largely to improved service delivery and expanded coverage.

Some of Latin America's leftist leaders have responded to this popular rejection of privatization by throwing the baby out with the bathwater. Rather than evaluating the process and examining the abuses it may have engendered, they have decided to return many public services and industries to State control. Venezuela's Hugo Chavez recently grabbed La Electricidad de Caracas, putting the capital city's electricity sector in government hands, as well as CANTV, the telecommunications company. Foreign investors in the oil industry were also forced to cede majority control in any joint ventures to the State or leave the country entirely. Bolivia's Evo Morales wasted no time after assuming office to nationalize the oil and gas sectors and then showed the door to the foreign firm that had run La Paz' waterworks since 1997.

Before other leaders jump on this bandwagon, they would do well to review the facts. If they do, they will find that privatization has actually been a godsend for many of their poor constituencies. Typically, privatizing public services results in rate increases, which disproportionately affect low-income groups. However, expanding service coverage has the opposite effect and tends to benefit groups that are on average even poorer. Overall, the impact on the poor is positive. Research confirms benefits to the lower classes in a number of cases in Latin America including electricity and water privatizations in Argentina, telephone, water and electricity in Bolivia and electricity in Nicaragua.

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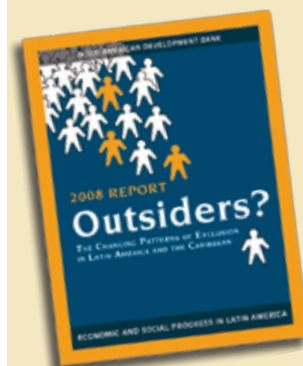
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COMING SOON!



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Still, this may be only the beginning of the story of the social and distributive effects of privatization. Even more startling is evidence of important benefits in the areas of health, time management and employment. For instance, thanks to the waterworks privatization in Argentina, many marginal neighborhoods that previously lacked service now enjoy water connections. As a result, cases of diarrhea decreased significantly and reported cases were less severe. Since service delivery improved dramatically, residents no longer had to hire cistern trucks to come to their homes or worse yet, rely on buckets of water from streams or buy bottled water. Even with higher prices, better service saved them both time and money.

In evaluating the Argentine electricity privatization, measuring the effect of good electricity service on the quality of food consumed in households and how this affects children's health produced remarkable results. Obviously, if the electricity supply is not stable and continuous, refrigerators do not operate well. As supply improved after privatization, refrigerators worked better, food did not spoil and studies confirm a reduction in low-weight births and infant mortality. In other words, there was a link between electricity privatization and healthier children!

In Peru, electricity privatization has been a blessing for farmers and poor rural workers. Thanks to more continuous and reliable electricity service, users can save time on agricultural work and use it partly for nonagricultural or leisure activities, thereby boosting both income and general wellbeing. Privatization of the telephone service has also benefited the rural poor. The government required the private company, Telefónica del Perú, to install public

telephone booths in randomly selected villages. Compared to residents in villages without booths, beneficiaries in the lucky towns enjoyed tangible improvements in income, especially non-agricultural, which is crucial for stabilizing rural incomes. True, government requirements rather than the goodwill of the private company were responsible for these benefits. But it is also true that the public company was either unable or unwilling to provide this type of service in the past.

Contrary to popular belief, privatizations can be socially very beneficial, but delivering these benefits to the poor requires the power of government to regulate companies. This issue of *IDEA*, which draws from a Latin American Research Network project on the welfare benefits of privatization and the 2008 Economic and Social Progress Report on social exclusion, looks at this unsung side of privatization and at the complementary regulation that could help boost its image.



In May 2007, the IDB Research Department (RES) launched a new service, **REVELA**, Revelation of Expectations in Latin America, which analyzes market expectations for growth and inflation across countries. Each month RES collects the results of surveys of market participants from Central Banks in the region. Using this data, RES produces a set of illustrative graphs and tables and draws conclusions regarding growth and inflationary trends in the region. To date, REVELA shows that while expectations of growth in Latin America remain high, they have now stabilized, even as generally subdued inflationary expectations have begun to rise. The report and underlying data is updated on a monthly basis and is available at www.iadb.org/RES/REVELA.cfm.

This issue of *IDEA* is based on research conducted by Alberto Chong, Gianmarco Leon, Florencio Lopez-de-Silanes and Máximo Torero, with the assistance of Vanessa Rios.

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IDEA (Ideas for Development in the Americas) is an economic and social policy newsletter published three times a year by the Research Department, Inter-American Development Bank. Comments are welcome and should be directed to *IDEA*'s managing editor, Rita Funaro at Ritaf@iadb.org.

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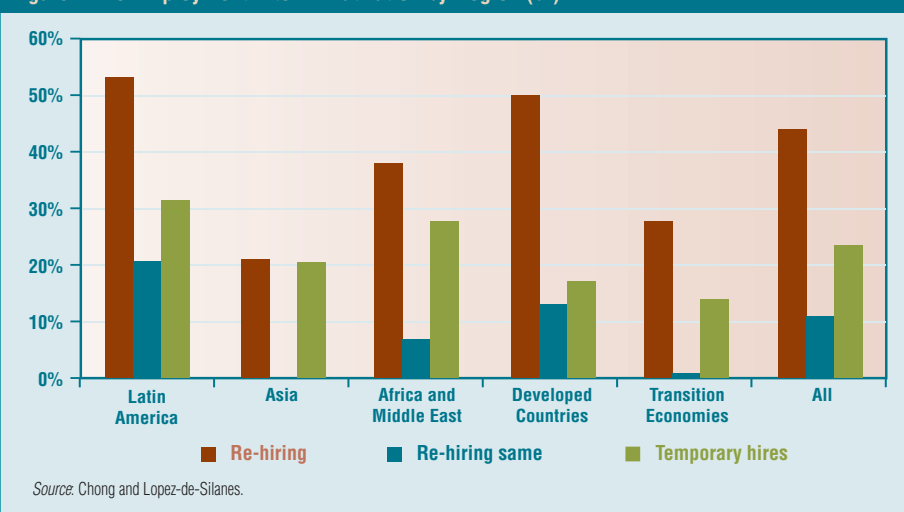
Do Workers Lose as a Result of Privatization?

Privatization inevitably generates both winners and losers and workers are generally thought to get the short end of the stick in this process. After all, one of the principal motivations for privatization is to improve efficiency, productivity and ultimately profitability and what easier way to do this than to cut payrolls. However, the privatization picture is not nearly as black and white as it is often painted. When looked at over time, the welfare effect of privatization on workers is far more complex than it appears at first blush.

Did privatization in Latin America improve productivity and efficiency? Studies of five Latin American countries say “yes.” Typically, after privatization, companies increased their net income to sales ratio by 14 percentage points, mainly through improved efficiency, as unit costs dropped by an average of 16%. Other indicators yield similar results. For example, the sales to assets ratio increased on average 26%, and the sales to employee indicator rose notably as well. In Chile and Mexico, the two most outstanding cases, the sales per employee ratio doubled in privatized companies and in certain companies those increases were several times larger. These results might at first glance seem to stem from simply lowering costs and reducing the workforce. In fact, however, in the wake of privatization these indicators improved even as company production substantially increased. Mexico and Colombia registered the greatest average gains of 68% and 59%, respectively. Brazil, which trailed the other countries in the study, increased production by a still impressive 17%.

Increasing productivity, however, is generally perceived to have come at the cost of labor force reductions and social benefit cuts. In particular, it is common-

Figure 1. Re-Employment After Privatization by Region (%)



ly believed that most workers dismissed from public enterprises are forced to enter the informal sector, thereby losing a stable source of income and access to social benefits. This view is not without a basis in fact: since public companies have often been used to create employment for political reasons, short-run job reductions were necessary to make these companies viable as part of the privatization process.

The magnitude of job losses due to privatization in six Latin American countries has varied widely. While industry-adjusted job losses in Chile averaged only about 5%, in Peru and Argentina the industry-adjusted average of job reduction in privatized state-owned enterprises (SOEs) was around 40%. However, the effect of privatizations on unemployment in Colombia seems to have been very modest, at least in the electricity sector, where most privatizations took place.

These short-term findings, however, do not tell the whole story of privatizations and employment. In the medium term, many firms rehired workers who

had initially been fired during the privatization processes—once it became clear that the “wrong” workers had been dismissed. As shown in Figure 1, privatizations in Latin America have offered a prime example of this so-called “adverse selection” problem. Since some workers who were let go did in fact end up in the informal sector, it is clear that privatization layoffs resulted in social exclusion, but this problem was in some cases mitigated by the rehiring of those workers.

Whether the efficiency gains from privatization were driven by productivity-enhancing investment, or by reductions in jobs and social benefits, remains unclear. While the limited evidence available suggests that labor cost reductions contribute to profitability gains after privatization, these savings do not explain the bulk of increased profitability. Moreover, job reductions are not the only means of increasing labor productivity and, even when they occur, they may be accompanied by other cost-cutting measures such as lower wages and benefits.

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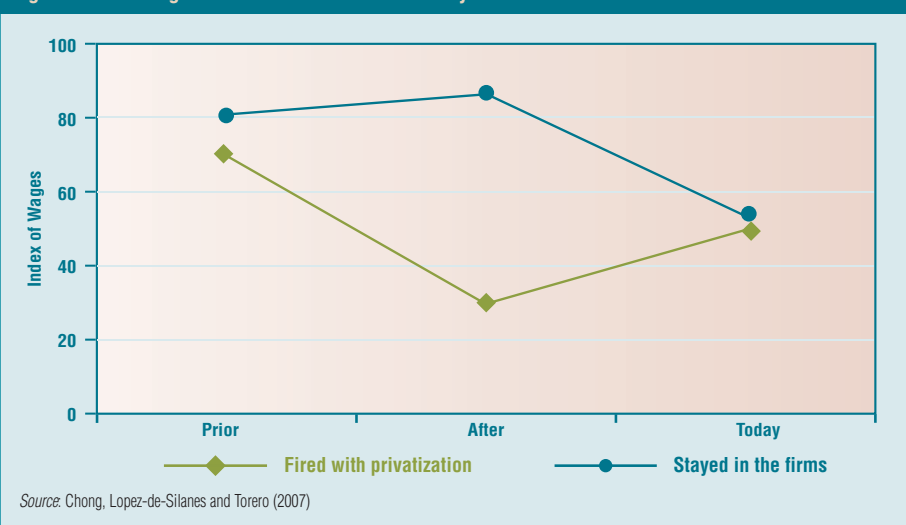
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Productivity, though, cannot be viewed in isolation. Taking into account other labor indicators, the evidence on the benefits of privatization is mixed. Managers in privatized firms earn significantly more than their counterparts in either state-owned firms or firms that have always been private, while the wages of lower-skilled workers in privatized firms do not differ significantly from similar workers in private or state-owned firms. On the other hand, working conditions appear to have deteriorated significantly in the transition from public to private ownership. In addition to labor deregulation throughout the region, the trend has clearly been to reduce non-wage labor costs, especially social benefits. In other words, privatized and private firms seem to be favoring temporary workers over permanent contracts, and employing more low-skilled workers. Under these circumstances, workers are less apt to organize, meaning privatized firms have significantly lower unionization rates than state-owned enterprises.

In some instances, though, productivity gains from privatization lead to higher wages and other forms of remuneration. In Mexico, wages in a broad sample of privatized companies increased an average of 76% from 1983 to 1994, well above the rest of the economy. Even more surprising, wages increased substantially more for blue-collar workers than for office staff (122% compared with 77% in the 1983–94 period). Workers in many privatized companies additionally benefited from ownership participation programs introduced to boost worker interest in privatization. In Colombia, average wages in privatized manufacturing firms increased by 25% after privatization. As in other countries, however, it appears that other labor conditions have deteriorated and the influence of labor unions has eroded.

Figure 2. Net Wages of Laid off Workers and stayers in Peru



What happened to workers who were laid off during the restructuring process either before or after privatization? This segment of the population, usually drawn from the groups that are most vulnerable to economic shocks of any kind, arguably faces the greatest risk of social exclusion due to privatization. In fact, one of the leading concerns surrounding privatization has been that laid-off workers may be unable to obtain a similar job in the private sector because of age, low skills, or the accumulation of human capital that is not transferable to other industries. Although data limitations have made it nearly impossible to seriously address this issue on a large scale in most countries, Chong, López-de-Silanes and Torero (2007) have analyzed the conditions of laid-off workers in Peru both before and 10 years after privatization. Even though laid-off workers were given a compensation package, the average worker suffered a significant initial hit after being fired, which validates concerns regarding the impact of privatization on inequality and social exclusion. On the other hand,

as illustrated in Figure 2, those workers' wages and benefits eventually recovered to the same level as those of private sector workers in their industry.

Perhaps more surprising is that "stayers" in Peru command higher wages and benefits than comparable workers who had been fired because of privatization or who had always been in the private sector. Workers in former SOEs were apparently able to extract more than other workers due to firm market power, union power or favorable terms of a collective contract that remains in effect. This result also helps explain why the compensation of workers who lost their jobs because of privatization reverts to the mean of their private sector industry.

Another interesting finding is that the typical worker consumes his compensation package within the first two years, usually by investing in his home or creating a self-run business. Unfortunately, however, the average new business fails by the end of that period and workers move on to activities related

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The Color of Privatization

Does discrimination play a role when laying off workers during the privatization process?

At first glance, the answer appears to be yes; but a closer look reveals that workers are dismissed more on the basis of their skills levels and other characteristics than on their race, ethnicity or gender. Apparently, discrimination—at least as it is traditionally understood—is not as widespread as it is thought to be, either in labor markets or in Latin American society as a whole.

A study of the privatization process in Peru examined the ethnicity of laid-off workers and found descriptive evidence of a bias against the non-white population. However, a statistical analysis considering a number of other factors refutes the discrimination hypothesis, at least when it comes to dismissing workers. Instead, the human capital endowments of individuals determined whether they were fired or not. Discrimination may, or may not, have been important in determining whether these individuals had the type of education or health care they needed throughout their lives to be competitive workers, but it was not the determining factor when they were laid off following privatization.

According to conventional wisdom, Latin America is a highly discriminatory society. However, the results of this study raise the question, who is discriminated against? The quintessential opinion survey of the region, *Latinobarómetro*, finds that most people in the region think there is some sort of discrimination. However, most Latin Americans do not believe that it operates against the traditionally discriminated groups (indigenous, Afro-descendants and women, to cite the most prominent, historical examples). Instead, they believe the poor are the ones who suffer

the most from unequal treatment. After the poor, Latin Americans believe that the uneducated, the elderly and those who lack proper social connections suffer the most from discrimination. Interestingly, nearly a quarter of respondents said they did not feel discriminated against at all. These perceptions of discrimination are counterintuitive and are summarized in Figure 3. They point towards the existence of some sort of discrimination derived on the basis of economic reasons, rather than biological or sociological factors.

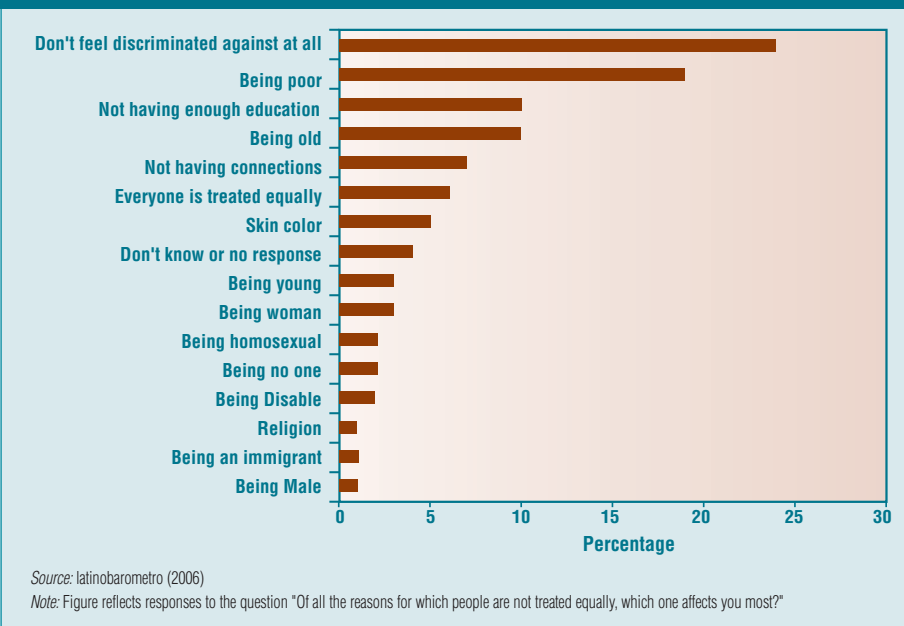
Studies of racial discrimination in labor income generation have focused on documenting earnings differentials between females and males, or indigenous and non-indigenous people, or Afro-descendants and whites. Comparisons of hourly labor earnings suggest the existence of notorious gaps. Depending on the estimates, non-indigenous workers earn between 80% and 140% more than indigenous ones. However,

non-indigenous workers exhibit human capital characteristics that are, on average, more desirable than those of indigenous workers. The most notorious of these characteristics has been education (schooling), but there have also been differences in labor market experience and field of specialization. Therefore, to attribute the whole earnings gap to the existence of labor market discrimination in pay would be misleading. At least a part of it can be traced to differences in observable human capital characteristics that the labor market rewards and, hence, has nothing to do with discrimination. Econometric techniques have helped to identify, to some degree, the magnitude of this component. In terms of racial earnings gaps, these differences in human capital characteristics account for more than one-half of the documented earnings gaps.

The evidence of discrimination (or, more precisely, earnings gaps that

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Figure 3. Reasons Cited for Unequal Treatment, 2006



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cannot be explained by differences in productive characteristics of individuals) that this type of study has found is notoriously smaller than what a simple comparison of earnings would suggest. Nonetheless, these studies have been criticized, particularly for their failure to truly identify discriminatory behaviors due to the presence of “unobservable characteristics.” That is, the human capital characteristics these studies can typically analyze are only those that are easily observable (schooling, labor market experience, field of specialization, sector choice, etc.), but there are other unobservable characteristics including entrepreneurship attitudes, motivation, work ethics, commitment and assertiveness. These characteristics are not captured in a survey (and in that sense, are not “observed”) but they are plain as day to an employer, or more generally, the relevant actors in the labor market.

Recent research on the so-called discriminatory practices in the region’s labor markets attempts to separate the effect of observable from unobservable characteristics. The results represent a giant step towards the goal of understanding discrimination and its channels, using tools that emphasize efforts to “observe the unobservables.” Interestingly, many of the results obtained from controlled experimental setups seem to contradict the idea that Latin Americans act discriminatorily nowadays. The evidence points towards the existence of stereotyping that vanishes when information is revealed. For instance, when choosing partners in an experimental investment game that depended not only on the individual’s decisions but also on the decisions of their peers, people showed a preference for women, tall and white-looking people. However, when given information on the past performance of other play-

ers, the information previously used to stereotype does not seem to matter any more. To some extent, there is also evidence that some sort of self-discrimination partially explains the discriminatory outcomes. Women asking for wages between 6% and 9% lower than those asked by their male counterparts is a case in point. Both stereotyping and self-discrimination are behaviors that may simply reflect the substantial differences in endowments of agents in the market. Under these circumstances, labor markets simply operate as resonance boxes that amplify differences that exist in other spheres.

Clearly, what most Latin Americans observe in their daily activities are substantial differences in human, physical, financial and social assets that are associated with gender, racial, ethnic and class distinctions. However, these differentiated outcomes cannot necessarily be blamed on the discriminatory practices of Latin Americans today. Unfortunately, the confusion between differentiated outcomes with discrimination has been commonplace in the academic discussion. This, in turn, has automatically translated to the public discourse and to the collective memories of societies.

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to their previous employment. These results contrast with the belief that workers lose in the long term after privatization and that workers who lose their jobs are condemned to unemployment or poverty. In general, workers laid off as a result of privatization suffer a serious setback at first, then quickly recover until their wages and benefits converge with those of similar workers in the private sector.

Summing up, the effect of privatization on workers cannot be judged categorically as good or bad. On the one hand, the role of the State as an entrepreneur is not limited to the efficiency and profitability concerns to which private enterprises are, and in this sense, the results in these areas of privatized versus public firms are not comparable at all. On the other hand,

there were some significant gains in absolute efficiency and productivity, but these improvements were done at the expense of workers’ social benefits, unionization rights, and labor composition. Nevertheless, a long-term comparison paints a much more optimistic picture. Over time, the welfare of workers who were laid off during the privatization process tends to converge with that of those in the private sector of the economy.

The bottom line is that privatizations were a necessary policy decision due to the failure of the State as a business administrator. In the short term, they exacted a high price from the labor force, but in the medium and long term, a convergence pattern ended up equalizing the welfare of those who were categorized as losers at first glance.

The Challenge for Governments: Regulation

Why do privatizations fail? A common element in many failures is inadequate regulation leading to low levels of competition, which gives producers free rein to keep the gains of privatization without sharing them with consumers. While critics like to use this as an argument against further privatization, the truth is that if privatization is done correctly, it can lead to social gains. The challenge for governments is to build an appropriate regulatory framework, particularly for utilities, which provide basic services to the poor.

There are two main instances in which regulation should be carefully analyzed in conjunction with privatization: industries characterized as natural monopolies or in which oligopolistic market structures exist; and industries in which the government owns most of the assets in the industry even if no individual firm has substantial market power. Sectors with a heavy state presence tend to be protected by a web of regulations whose original intent was to cut state-owned enterprises' (SOE) losses and reduce fiscal deficits. In some of these cases, the regulatory effort needed can be better understood as deregulation to get rid of protective structures that shield companies from competition and allow privatized firms to make extraordinary gains at the expense of consumers. Competition and regulation should be carefully considered as part of the aftermath of the privatization process. Adequate regulation can produce efficiency improvements that benefit both consumers and producers. In cases of sectors with oligopolistic power, regulation must be complemented with a new package of rules and disclosures to enhance supervision and reduce abuse of market power. Regulation of oligopolistic sec-

tors is complicated because of weakness in regulatory governance.

There are two ways in which credible regulation complements privatization. At the most basic level, product market competition provides a tool to weed out the least efficient firms. This process may take too long, or not work at all, if regulation inhibits new entry or makes exit costly. An analysis of the effects of telecommunications' privatization and regulation in Latin America and Africa shows that competition from mobile operators and privatization combined with the existence of a separate regulator are significantly associated with increases in labor efficiency, mainlines per capita and connection capacity. The implication is that privatization of oligopolistic industries with concurrent reforms may improve welfare, especially as it improves service. An additional bonus is that countries in which a regulatory agency existed prior to privatization were able to fetch higher privatization prices and thus provide governments with greater revenue that could be used for investment and social programs.

Secondly, adequate regulation may also complement privatization by raising the cost of political intervention. Whereas an inefficient monopoly can squander its rents without endangering its existence, an inefficient firm in a competitive industry needs a subsidy to stay afloat. The introduction of competition forces politicians to have to pay firms directly to engage in politically motivated actions whereas before the costs of these measures were absorbed by an SOE that did not have to worry about market performance. In fact, competition is often restricted precisely because it raises the costs of political influence. Colombia and Mexico provide good examples of adequate deregulatory policy actions

that, when coupled with privatization, can be used as a lever to transform the economic landscape and reduce political interference in the economy. In the early 1990s, Colombia began an economic liberalization program through the promotion of market competition and deregulation. Privatization was conceived as an instrument for achieving both of these objectives. A decade earlier, Mexico started to transform its previously closed economy characterized by capital controls, price regulation, restrictions on foreign direct investment, high tariffs, import quotas and a large state-owned public sector. As in the case of Colombia, privatization coupled with deregulation played a key role in the drive to restructure the economy and help privatized state-owned enterprises catch up to their private peers.

Generally speaking, adequate regulation can take place at three different moments: before privatization, at the time of privatization or after the SOE has been sold. The literature has emphasized the importance of having efficient regulation at an early stage. Regulation before privatization of the industry may increase the pace of divestiture and help sell companies at a higher price if it reduces regulatory risk. However, establishing effective pre-privatization regulation is easier said than done. To begin with, regulatory changes prior to privatization are likely to lower SOE profits, translating into higher financial needs for the government at a very difficult time. Moreover, without the pressure of imminent privatization, the political will for a true regulatory reform might not materialize. Finally, governments with little experience in privatization often find it difficult to carry out an

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New Publications

RESEARCH DEPARTMENT WORKING PAPERS

On the Determinants of International Currency Choice: Will the Euro Dominate the World? (WP-611)

Matteo Bobba, Giuseppe Della Corte and
Andrew Powell

Money is used as a store of value, a medium of exchange and a unit of account. Most recent analyses of currency choice in an international setting have focused on the denomination of reserves—the store of value role. This paper focuses on currency choice for the unit of account role. Exploiting the creation of the Euro, the paper finds a large and significant Euro liquidity effect at the cost of the dollar, especially in the early years of the new currency. The estimates suggest that the Euro is making significant progress toward threatening the role of the dollar as the dominant international currency.

Debt Sustainability under Catastrophic Risk: The Case for Government Budget Insurance (WP-607)

Eduardo Borensztein,
Eduardo A. Cavallo and Patricio
Valenzuela

The Caribbean region, one of the more disaster-prone areas of the world, has the lowest levels of insurance coverage. This paper examines the vulnerability of Belize's public finance to the occurrence of hurricanes and the potential impact of insurance instruments in reducing that vulnerability. The paper finds that catastrophic risk insurance significantly improves Belize's debt sustainability. In addition, the methodology employed makes it possible to estimate the appropriate level of insurance, which for the case of Belize is a maximum coverage of US\$120 million per year. International organizations can help countries overcome distortions in insurance markets and relax internal political resistance to the purchase of insurance policies.

Output Volatility and Openness to Trade: A Reassessment (WP-604)

Eduardo Cavallo

This paper presents new empirical evidence suggesting that the net effect of trade openness on output volatility is stabilizing. The results confirm that exposure to trade raises output volatility through the terms-of-trade channel, but also shows that this is counteracted by a quantitatively larger stabilizing effect. The latter effect comes (at least in part) through the financial channel. The stabilizing effect of commercial trade predominates in countries that are more exposed to capital flows as compared to countries that are less exposed.

The Determinants of Corporate Risk in Emerging Markets: An Option-Adjusted Spread Analysis (WP-602)

Eduardo Cavallo and Patricio Valenzuela

This study finds that corporate bond spreads in emerging market economies are determined by firm-specific variables, bond characteristics, macroeconomic conditions, sovereign risk, and global factors. Firm-level characteristics account for the larger share of the variance. In addition, the paper finds two asymmetries. The first is in line with the sovereign ceiling "lite" hypothesis, which states that the transfer of risk from the sovereign to the private sector is less than 1 to 1. The second is consistent with the popular notion that panics are common in emerging markets where investors are less informed and more prone to herding.

Institutional Quality and Government Efficiency (WP-606)

Alberto Chong and Mark Gradstein

Poorer countries have a much smaller public sector and correspondingly a smaller tax burden than richer countries yet, their economic performance has not been necessarily better. Using a simple model, this paper suggests that the growth and welfare effects of taxation are mediated through institutional quality; consequently, optimal tax levels

increase with improved institutional quality. The paper also finds that a higher level of institutional quality bolsters positive firm-level perceptions of the quality of public services while at the same time moderating the view of taxes as an obstacle to growth.

Privatized Firms, Rule of Law and Labor Outcomes in Emerging Markets (WP-608)

Alberto Chong and Gianmarco Leon

This paper compares labor indicators of privatized, private, and public firms around the world, particularly wages, benefits, labor composition, education and training, unionization, and quality of management. While labor productivity increases after privatization, the ratio of permanent workers to temporary workers also increases. Convergence depends to some degree on the quality of the institutions, namely, the rule of law. Not only is this true for the ratio of permanent workers to temporary workers, but also for education of the workforce, and for the manager's years of experience. On the other hand, the rule of law appears to be less important in the case of labor productivity and training.

The Educational Gender Gap in Latin America and the Caribbean (WP-600)

Suzanne Duryea, Sebastian Galiani,
Hugo Nopo and Claudia Piras,

This paper analyzes the evolution of gender differences in school attendance and attainment in Latin America and the Caribbean, for both adults who left the educational system and children in school. The results indicate that the schooling gap has closed for the cohort born at the end of the 1960s. Since then, the gap has reversed such that females within the cohort born in 1980 have, on average, $\frac{1}{4}$ of a schooling year more than males. From 1940 to 1980 the gender gap in attainment has moved in favor of females at a pace of 0.27 years of schooling per decade. In Bolivia, Guate-

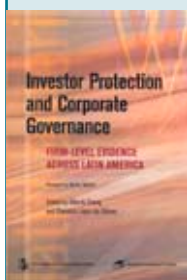
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New Publications

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mala, Mexico and Peru (the countries that have not closed the gap in adult schooling attainment) there are noticeable gender differences favoring boys only among older children of the lowest income quintiles and indigenous ethnicity.

BOOKS



Investor Protection and Corporate Governance: Firm-Level Evidence from Across Latin America

Alberto Chong and Florencio Lopez-de-Silanes, eds.
Stanford University

Press, Palo Alto and World Bank Press, Washington, DC; June, 2007.

This book analyzes recent trends in investor protection in Latin America. Based on firm-level data for six countries, the book shows that, like legal protection of investors, appropriate firm-level corporate governance is linked to lower costs for capital, better valuation, performance, and dividend payments across countries. Firms can compensate for their countries' legal deficiencies with improved corporate governance practices, thus increasing transparency and limiting potential conflict between large and minority shareholders. Firms and regulators must improve their governance structures and shareholder protection if they are to meet the improved benchmarks of developed nations brought about by Asian, European, and U.S. scandals in recent years.

OTHER PUBLICATIONS

Rent Seeking and Democracy: Empirical Evidence for Uruguay.

Cesar Calderon and Alberto Chong
Economic Inquiry, Vol. 45, 3: 592–601, July
This paper provides evidence for Granger-causality between rent-seeking behavior and democracy in Uruguay, where both rent-

seeking behavior and political shifts have varied widely in the last 80 years, but where ethno-linguistic heterogeneity and inequality have remained low. This helps identify “pure” interactions and their link with rent-seeking outcomes. The presence and duration of democracy appear to have been conducive to a decrease in rent seeking, although the reduction in rent seeking does not appear to have had a bearing on the quality of democratic regime. While the duration of democratic regime may impact rent-seeking behavior, rent seeking also displays a Granger-causality to democratic duration.

Institutional Enforcement, Labor-Market Rigidities, and Economic Performance.

Cesar Calderon, Alberto Chong, and Gianmarco Leon
Emerging Markets Review, Volume 8, Issue 1, March 2007, Pages 38–49

This paper compares non-enforceable and enforceable measures of labor rigidities as a measure of the quality of labor institutions, and tests whether such labor rigidities are conducive to long-run growth. It finds that non-enforceable labor regulations do not have a bearing on economic growth, but enforceable labor regulations do. It appears that labor rigidities are negatively linked with long-run economic growth.

Where Did You Go to School? Private-Public Differences in schooling trajectories and their Role in Earnings Determination.

Sebastian Calonico and Hugo Ñopo
Wellbeing and Social Policy Journal. Vol 3, No. 1. 2007

This paper explores private-public differences in the individual returns to education in urban Peru. The results indicate higher returns to education for those who attended private schools compared to those who attended the public system. However, there was wider quality heterogeneity within the private system. The private-public differences in returns are more pronounced at the

secondary than at any other educational level. On the other hand, the private-public differences in returns from technical education are almost nonexistent.

Should State-Owned Firms Change CEOs before Privatization? Some Evidence From the Telecommunications Industry

Alberto Chong and Virgilio Galdo
Applied Economics Letters, Volume 14, Issue 8 June 2007, pages 591–595

Considering 77 telecommunications privatizations, which account for nearly 80% of the sector in terms of value, this paper finds that CEO replacement will improve performance in the telecommunications industry before privatization as measured by penetration, operating efficiency, and profitability. CEO change before privatization does appear to have real consequences in firm performance before privatization. Moreover, findings are consistent with previous research that links CEO replacement and an increase in privatization prices.

Institutions and Inequality.

Alberto Chong and Mark Gradstein.
The Review of Economics and Statistics, Vol. 89, Issue 3. August 2007

This paper presents theory and evidence on the relationship between inequality and institutional quality. It presents a model in which the two may dynamically reinforce each other and tests this relationship with a broad array of institutional measures. The double causality between institutional strength and a more equal distribution of income is empirically established.

Barriers to Exit

Alberto Chong and Gianmarco Leon.
Economics Letters. July 2007.

Unlike previous work on barriers to entry in international trade, this paper tests four theories on barriers to exit, and finds that macroeconomic factors and the brain drain

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New Publications

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explain them, while institutional and cultural hypotheses are not empirically robust.

Bundling in the Provision of Public Services: Evidence for Peru

Alberto Chong, Jaime Saavedra and Jesko Hentschel

Oxford Development Studies, Vol. 35, Issue 3, 2007.

Using panel data for Peru for the period 1994-2000, this paper finds that household welfare increases, as measured by changes in consumption, are larger when households receive two or more services jointly than when services are provided separately. Such increases appear to be more than proportional, as F-tests on the coefficients of the corresponding regressors confirm.

Thus, bundling of services may help realize welfare effects, especially in urban areas.

International Remittances and Income Inequality: An Empirical Investigation.

Valerie Koechlin and Gianmarco Leon

Journal of Policy Reform, Vol. 10(2).

June, 2007.

This paper provides evidence of an inverted U-shaped relationship between international remittances and income inequality in a cross section of 78 countries. The analysis shows how, in the early stages of migration, remittances increase income inequality. Then, as the opportunity cost of migrating decreases due to this effect, remittances tend to lower inequality. Education and the development of the financial sector can help

countries reach the inequality-decreasing stage more rapidly.

Ethnicity and Earnings in a Mixed Race Labor Market.

Hugo Ñopo, Jaime Saavedra and Maximo Torero.

Economic Development and Cultural Change, Vol. 55, No. 4, July, 2007.

This study examines the relationship between earnings and racial differences in urban Peru. Estimates from a semi-parametric model show evidence of a race premium for whiteness on earnings, statistically significant among wage earners but not among the self-employed. These results may be consistent with a story of employer discrimination.

The Challenge for Governments: Regulation

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effective pre-privatization regulatory reform.

Regulation at the time of privatization solves the first two problems and reduces regulatory risk discounts. As long as a suitable regulatory framework is in place at or before the time of privatization, both consumers and the government should benefit from the process. Governments that lack regulatory capabilities at the time of privatization and want to maximize sales prices have often postponed full and clear regulation. Trying to establish an adequate regulatory scheme after privatization may be problematic from a political economy perspective. Since the agency in charge of enforcing and regulating the contracts is often the same or subordinated to the agency that carried out the privatization, there is an incentive for lax enforcement to avoid exposing past mistakes. For numerous concessions in infrastructure projects, the private sector was able to bargain

and maintain protective regulation after privatization because of the threat of bankruptcy, withdrawal, or desertion of future investment commitments. All of these impact the reputation and credibility of privatizing politicians. In the last 15 years, concession contracts in developing countries have often led to renegotiations. In Latin America and the Caribbean, 40% of all concession contracts were renegotiated just over 2.2 years after they were signed. These opportunistic renegotiations of concessions are common because of what is called a “privatize now, regulate later” approach. Cost overruns in concessions and unclear rules governing contingencies provide private owners with the opportunity to extract economic rents from the government. Finally, attempting to substantially alter the regulatory framework after the sale may also prove difficult as new constituencies against regulation are created at the time of privatization. Shareholders

and managers of privatized state-owned enterprises are joined by workers and even consumers who could benefit from the protective regulatory status of firms.

Regulation’s performance cannot be assessed in isolation. Regulation can be viewed as a component of the “institutional possibility frontier” of an industrial sector. Other components might include the antitrust bodies, the courts, the authorities at the executive, national and local levels, and the sector ministry, in the case of utilities.

Adequate regulation can make privatization work—for governments and for consumers. Assuring that privatized firms operate in a competitive environment at the service of their clients rather than their stockholders is key to achieving the goal of a more efficient, productive and equitable economy. It may also help change the face of privatization in the eyes of public opinion.



Look Who's Talking

This section of the newsletter spotlights presentations or events sponsored by RES.

Global Imbalances and Risk Management: Has the Center Become the Periphery?

The Inter-American Development Bank and the Asociación para el Progreso de la Dirección (APD) brought together distinguished academics and financial experts in Madrid, Spain last year for a conference jointly sponsored by Banco de Bilbao y Vizcaya y Argentinaria (BBVA) and Fundación Rafael del Pino. The goal of this event was to better understand the global imbalances situation and assess the risks of a possible abrupt change in capital markets, with *particular attention to emerging markets*. The conference was put together by Alejandro Izquierdo and Carlos Quijano. A website with papers, presentations and videos of the conference is now available and can be accessed at <http://www.iadb.org/res/imbalances.cfm>.

An increasingly integrated global economy presents both opportunities and challenges. While a global capital market is widely believed to improve the allocation of resources, it has often been associated with increasing volatility, and the prospect of volatility raises concern in the present climate of current account imbalances. In recent years the central banks of China, Japan and other East Asian countries, as well as those of India and oil-exporting countries, have accumulated significant dollar reserves. This stands in stark contrast to uninterrupted growth in U.S. current account deficits since the early 1990s, reaching approximately 7 percent of GDP in 2006, depicting a curious situation in which “the center” is now being financed by “the periphery.”

Many observers see the current situation as unsustainable. In fact, some warn of an abrupt change and adjustment that would destabilize financial markets and bring about a “Sudden Stop” in capital flows, which would in turn have a disruptive impact on emerging markets and possibly trigger a systemic crisis in the world economy.

The conference’s overarching theme was financial globalization, particularly the issue of *changes in financial globalization*, and the ability of economies to safely adapt to this important change. The present era is not without precedent, however, as it echoes a previous period of globalization in the late nineteenth and early twentieth centuries. Back then, just like at the end of the twentieth century, unforeseen phenomena such as Sudden Stops in capital flows materialized, in a context of domestic vulnerabilities such as Original Sin, and domestic liability dollarization in emerging economies. The combination of incomplete markets and increased globalization led to dramatic disruptions in financial markets, as illustrated by responses to the 1998 Russian default.

In the current context of global imbalances and greater financial integration, most participants agreed that short-term prospects for global financial markets remain favorable and that the U.S. current account deficit should be financed with little difficulty over the next two years. Prospects five years ahead look far less certain, however, as evidenced by participants’ sharply diverging views. In fact, several in attendance maintained that the short-term outlook is subject to significant vulnerabilities, and that new unexpected and abrupt changes could lead to disorderly adjustment and a sharp reduction in worldwide economic growth, with a particularly serious impact on some emerging markets. An alternative scenario envisioned increases in US interest rates that could actually lead to a “flight to quality” with capital flowing from emerging markets to the US, dampening the impact on the US while worsening that on emerging economies.

While markets are very good at dealing with shocks that are regularly on their radar, they are generally far less adept at managing infrequent surprises. A shock with origins outside of investors’ usual perspective,

such as a war between the United States and Iran, might result in an oil shock, and the combination of an oil shock and imbalances could greatly complicate the world financial system. Another source of uncertainty is the creation of new financial instruments, such as those traded in derivative markets (credit default swaps for example), which have grown considerably in a context of scarce public information about their size and nature, and with minimal regulation. Unexpected turmoil in those markets, combined with global imbalances, could prove to be a dangerous cocktail. Present and future concerns notwithstanding, it would be unwise to extrapolate future trends on the basis of previous crisis episodes, as learning has taken place in markets and instruments have been developed to lessen the likelihood of such episodes’ recurring.

Alejandro Bonvecchi presented a policy seminar on Leadership, Capacity and Crisis of Institutional Reforms in Latin America, May 11, 2007.

Explanations for institutional change in Latin America, particularly change in fiscal institutions, have been primarily either structure-based or actor-based.

Structure-based explanations view such change as stemming from economic crises and/or the diffusion of policy ideas. The process of institutional change is mediated by the following factors: state capacities, political regime type, party system, level of electoral competition, and patterns of representation of subnational political units. The nature of the change that results encompasses both the diffusion of policy ideas and an adjustment in state capacities to a new environment.

Actor-based explanations, on the other hand, see institutional change as originat-

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Look Who's Talking

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ing from a variety of sources: pressure on governments by a variety of actors (including multilateral lenders and private-sector financial institutions); electoral mandates; policymakers' perceptions of risk; changes of personnel in elite positions; and autonomous strategic choices made by policymakers. The subsequent process of institutional change depends on the organization and relative strength of actors; relations between governments and economic actors; relations between the executive branch and the country's ruling party; and actors' perceptions of risk in a given scenario. The nature of the resulting institutional change can consequently be examined in terms of changes in actors' internal configuration and organizational strength, as well as the institutional leverage of some actors over others.

While each of these approaches holds some explanatory power, an integrated approach offers a more nuanced and realistic account of institutional change that encompasses four hypotheses:

1. Change occurs when governments perceive the status quo to be highly risky, whether as a result of crisis situations or pressure from international financial institutions or financial-market actors.
2. Processes of institutional change are fast and deep to the extent that the following conditions apply: i) there are a small number of veto players; ii) veto players are weak and fiscally dependent; and iii) bargaining is coordinated and far-reaching in its coverage.
3. The distance of changes from the status quo is determined by the extent to

which existing policy legacies are discredited, the flexibility of administrative structures, and the strength of national party leaders.

4. Processes of institutional change are centralizing to the extent that the following conditions apply: i) administrative structures are flexible; ii) national party leaders are strong; iii) national peak organizations are disciplined and strong; and iv) particularistic legislators, regional peak associations and subnational party leaders are weak.

The general hypotheses derived from an integrated explanation further lead to an extensive series of more specific hypotheses regarding changes in budgetary rules, taxation, social security systems and fiscal federalism.



Network News

Latin American Research Network Quality of Life in Latin America and the Caribbean

On the occasion of the 50th anniversary of the Inter-American Development Bank, the Economic and Social Progress Report (IPES) will be dedicated to an analysis of the quality of life of the people of Latin America and the Caribbean. Areas to be studied include educational quality and access, the quality of jobs, public safety, and the quality of housing and public infrastructure. To prepare for this report, the Research Department is launching three Research Network projects on different aspects of the quality of life:

- The Quality of Education in Latin America and the Caribbean
- Understanding Quality of Life in Latin America and the Caribbean: A Multidimensional approach
- Quality of Life in Urban Neighborhoods in Latin America and the Caribbean

Institutes selected to participate in the Quality of Education study are:

- FIEL - Fundación de Investigaciones Económicas Latinoamericanas, Argentina
- Fundación ARU, Bolivia
- Instituto Futuro & Escola de Economia de São Paulo, Fundação Getúlio Vargas, Brasil
- MIDE UC - Centro de Medición, Escuela de Psicología, Pontificia Universidad Católica de Chile
- Spectron Desarrollo S.C. México
- Instituto Desarrollo, Paraguay
- ABT Asociados Inc., Perú

Proposals for the other two studies are due August 1, 2007 and winners will be announced on August 10, 2007.

www.iadb.org/res/laresnetwork.cfm

Latin American Financial Network

The Fourth Workshop of the Latin American Financial Network (LFN) will be held at the Universidad de los Andes in Bogota, Colombia on October 3, 2007, immediately preceding the LACEA/LAMES Annual Meeting. The LFN seeks papers on any topic in finance, although preference will be given to papers with relevance to emerging economies. The workshop will be organized by selecting a small number of these papers, which will be discussed in thematic sessions.

Keynote speakers:

Guillermo Calvo, Columbia University
Roberto Rogobón, MIT

Organizers:

Arturo Galindo, ASOBANCARIA
Alejandro Gaviria,
Universidad de los Andes
Andrew Powell,
Inter-American Development Bank

www.iadb.org/res/lfn