

Politicization of Public Services¹

Because regulation...is sometimes used to promote redistributive or ideological purposes...it can be highly politicized.

—Oliver Williamson, *Public and Private Bureaus*

The policymaking process (PMP) strongly influences the quality of the regulation of public services (telecommunications, electricity, gas, water and sanitation, and the like). As in other policy areas, the stability, adaptability, credibility, and transparency of policies depend on how they are proposed, discussed, and put into action. The regulation of public services does not emerge solely from technical criteria aimed at designing the economically ideal system of incentives. In practice, regulatory mechanisms and institutions are the result of complex processes of political negotiation, which in turn are affected by the inherent characteristics of the regulated sectors and of underlying political institutions. In each country, these institutions are shaped by history, values, and other factors unique to the country. All these factors set the limits within which the actors involved in these processes can act.

Unlike the case of tax policy, analyzed in Chapter 8, in which the tax policymaking process mirrors the country's general policymaking process, the policymaking process for the public services sectors is molded not only by how policies are formulated in general in each country, but also by the characteristics and institutions specific to these sectors. Reform policies often alter the domestic institutional arrangement in these sectors; thus reforms can also affect how policy is made in the future. So, while the general political ground rules tend to persist over time, the relevant elements of the political game in the area of public services tend to change considerably during the actual process of reforming these sectors. This is because new key agents appear (such as new companies), new forms of interaction emerge (based on explicit contracts or new legal conditions, for example), and new political alignments develop for strategic or ideological reasons (for or against certain forms of ownership).

¹ This chapter is based on Bergara and Pereyra (2005).

Why are regulatory policies so susceptible to politicization? The explanation lies with three features that characterize the sectors. First, public services require large specific and permanent fixed investments (which economists call “sunk costs” because they cannot be recovered for alternative uses). Second, they have large economies of scale and scope. For example, electricity may be generated more cheaply in generators exceeding a certain size, and the same can be said of water treatment plants. Although electricity and water may be delivered by different suppliers, it makes no sense for each generator to have its own distribution network. Third, public services are consumed by very extensive groups within the population.

Although none of these features is decisive, the combination of all three works in favor of the politicization of regulation of the sectors. As Spiller and Tommasi note:

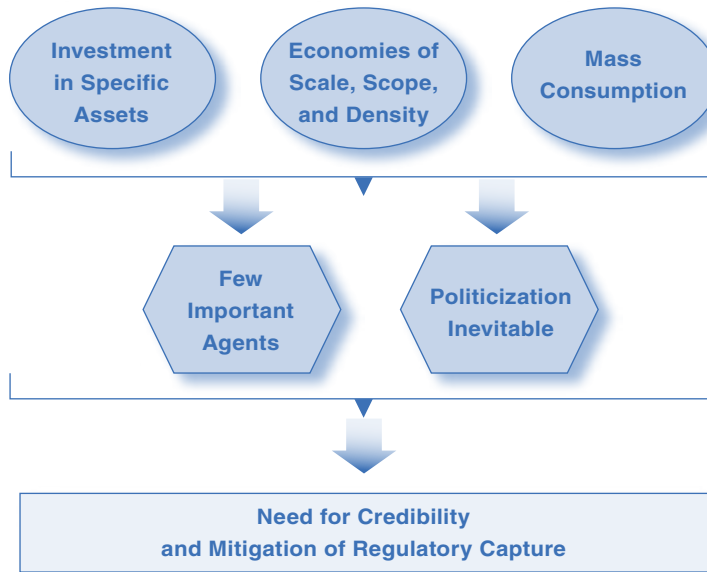
First, the fact that a large component of infrastructure investments is sunk implies that once the investment is undertaken the operator will be willing to continue operating as long as operating revenues exceed operating costs. Since operating costs do not include a return on sunk investments (but only on the alternative value of these assets), the operating company will be willing to operate even if prices are below total average costs. Second, economies of scale imply that in most utility services, there will be few suppliers in each locality. Thus the whiff of monopoly will always surround utility operations.

Finally, the fact that utility services tend to be massively consumed, and thus that the set of consumers closely approximates the set of voters, implies that politicians and interest groups will care about the level of utility pricing. Thus massive consumption, economies of scale, and sunk investments provide governments (either national or local) with the opportunity to behave opportunistically vis-à-vis the investing company. For example, after the investment is sunk, the government may try to restrict the operating company’s pricing flexibility, may require the company to undertake special investments, purchasing, or employment patterns, or may try to restrict the movement of capital. All these are attempts to expropriate the company’s sunk costs by administrative measures. Thus expropriation may be indirect and undertaken by subtle means.²

While the risk of expropriation of public utility companies is serious, it is only one of the political risks that can hamper the functioning of the public services sectors. Another risk is capture of regulatory agencies by the regulated companies. These companies have much at stake in the process of regulation. They are typically endowed with abundant resources and often engage in different activities to influence policy outcomes in their favor (such as lobbying, and sometimes even outright corruption) to try to capture the executive bodies or the regulatory agencies that set the parameters within which these companies operate (see Figure 9.1).

Because of the possibilities of politicization, the institutional environment plays a crucial role. Well-functioning institutions can provide credibility and stability to policies in these markets. They can also limit the possibility that the regulated firms will capture the executive bodies or regulating agencies in charge of defining and enforcing the rules of the game.

² Spiller and Tommasi (2005, p. 519).

Figure 9.1 Characteristics of Public Services


Source: Authors' compilation.

The incentives for expropriation tend to be stronger under certain conditions:

1. When formal and informal procedures for decision making are not well established.
2. When regulatory decision making is centralized in agencies that are subordinated to the executive and are susceptible to political pressure.
3. When the judicial system does not have the tradition or the power to review all administrative decisions.
4. When the government's time horizon is relatively short.

To reduce the risks to investors of expropriation, and to prevent investors from influencing the design of the policies in their favor, the design of the relevant institutions must lend credibility to the policymaking process. In this respect, the promise that investors' rights will be respected and that their obligations will be enforced must be credible.

Although all the public services sectors share the three characteristics mentioned above as making them particularly susceptible to politicization, they differ with respect to whether competition is technically possible and, if so, how rapidly competition can translate into visible results. For example, it is easier to generate competition in the telecommunications sector than in the electricity sector. Moreover, competition in in-

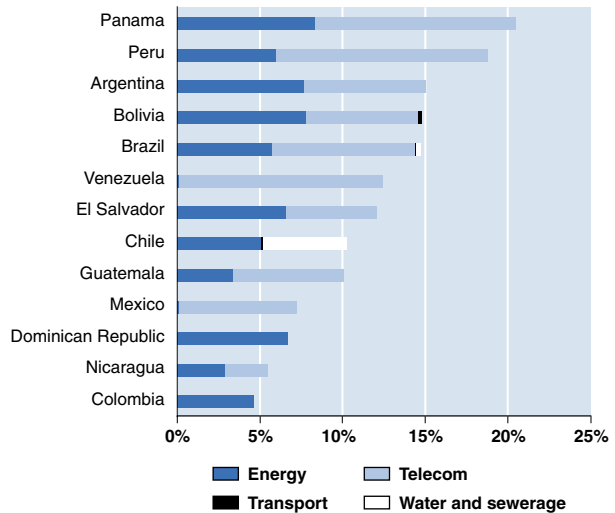
ternational long-distance telephony and cellular telephony produces improvements in efficiency, yields price reductions, introduces new services, and increases market volume more efficiently than the introduction of competition into the energy sectors. Obviously, these aspects are crucial for the success and long-term sustainability of reforms.

Various attempts have been made to reform public services markets in Latin America. The most notable have been those related to the areas of telecommunications, energy, and water and sanitation. In the 1990s, governments, with the help of international organizations, made great efforts to find mechanisms to privatize companies that had traditionally provided these basic services.

The outcomes were very mixed because the intensity of the privatization process differed greatly from one country to another (see Figure 9.2) and because the processes were not always introduced and carried through as part of a clearly defined strategy to restructure the affected sectors. Rather the reforms were often a response to the fiscal needs of governments, to political circumstances that favored potential buyers, and even to purely personal factors. The common element in the processes was politicization—the result of the three characteristics of the services sectors described above. Such politicization has often acquired ideological trappings, in a struggle between the virtues and vices of “market” versus “State.”

The attempts at privatization in the 1990s yielded mixed results, particularly in countries such as Argentina and Peru, where the quality and coverage of public services were very low at the outset. In these cases, State provision of the services had proven to be basically deficient. This experience, added to the government’s fiscal needs and a political environment more open to supporting privatization, initially facilitated the sale of assets and the participation of private agents in the provision of services. Since the crux of the discussion was the relative virtues of different forms of ownership, the central aspect of the process was privatization rather than the introduction of a competitive framework, especially in the case of telecommunications, where in several countries the State monopoly was simply replaced by a private monopoly.

FIGURE 9.2 Total Private Investment in the Infrastructure Sectors in Latin America, 1990–2003^a (as percentage of GDP)



^a Includes investment in acquiring government assets and investment in facilities.

Note: Cumulative values of the investments as a percentage of the annual gross domestic product.

Source: Authors' calculations based on World Bank (2005) and World Bank (various years).

The incomplete implementation and limited results led many to question the approach of the reform adopted. For reasons of substantial technological progress, as in the case of telecommunications, the approach to the reforms gradually changed, giving primacy to competition and leaving the nature of the ownership of the companies that provide the public services as a secondary consideration. In electricity, for reasons of organizational learning, the ground rules themselves acquired more importance, apart from whether they applied to public or private companies, and whether competition could be introduced.

In this process of promoting competition and regulating the noncompetitive segments of the market (for instance, electricity or water distribution), it has become critically important to set up regulatory agencies that are independent from economic agents, particularly existing companies. The creation and strengthening of these agencies is part of a process of redesign of the role of the State that aims to define who is responsible for policy design, who is responsible for the regulation of the market, and who is responsible for providing the service, in cases where State companies still exist. As part of this process, the creation and design of regulatory agencies has been the subject of considerable debate and institutional dispute.

Debate has also centered on the institutional location of the regulatory agencies, as well as their relation to the authorities responsible for overseeing competition. In all these aspects of regulation, the difficult balance between technical and political criteria has been affected by institutional constraints. The case studies below illustrate these points.

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Case Studies

Institutional Weakness and Volatile Results: The Case of Argentina

Since the early efforts at reform in the sector, public services policy in Argentina has been characterized by volatility, considerable influence by special interests, and insufficient attention to the institutional capacity of the regulatory agencies.

The opening of telecommunications to the private sector in the early 1990s was Argentina's first experience with privatization. At that time, telecommunications services were provided by *Empresa Nacional de Telecomunicaciones* (ENTEL), a public company with a legal monopoly, which suffered from major financial and administrative problems that impacted the quality of service and the network's rate of expansion. After ENTEL was privatized, the provision of telecommunications services was in the hands of two companies (*Telefónica* and *Telecom*), which operated in the southern and northern parts of Argentina, respectively, and shared the Buenos Aires market equally. These companies acquired exclusive operating licenses for basic services (voice transmission except mobile telephony)

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for seven years. This exclusivity was intended to trigger an accelerated investment process, in order to boost development of Argentina's telecommunications capacity (and increase the proceeds of the sale). For this, the companies made specific investment commitments to expand the network and improve the quality of the service. At the same time, a regulatory agency, the National Telecommunications Commission (CNT), was established, but it operated independently for only one year. In 1991, the executive intervened and placed the CNT under the control of the ministry of public works.

In March 1998, a telecommunications liberalization plan was approved. It implemented the decision to move the sector gradually toward competition. New licenses were granted for basic services, which favored existing operators, whether providers of fixed or mobile telephony, or other services. The exclusive licenses for the telephony providers were extended for two more years (until 1999), even though they had not fully complied with their investment commitments.

The absence of adequate institutions to manage the regulation process has helped make policies in the telecommunications sector even more volatile than in other infrastructure sectors in Argentina, where regulators have maintained greater independence. It is therefore not surprising that the most serious conflict over regulation of public services in Argentina during the 1990s took place in the telecommunications sector. At issue were the criteria for tariff-setting, following the introduction of exchange rate convertibility in 1991. A special feature of telecommunications privatization (compared with the processes for other public services that came later) was that the preexisting tariff structure was transferred to the new operators. This structure entailed a series of cross-subsidies that were even higher than those that had historically existed in the country. When peso-dollar parity was adopted, firms were prevented from adjusting tariffs in line with the consumer price index (CPI), undermining the arrangement of price cap regulation with indexation to the CPI that had been established in the privatization agreement.

In 1996, the ministry of economics took control of negotiations with the firms, assuming the place of the regulator. Tariffs and adjustments to them were dollarized: in line not with prices in Argentina, but with prices in the United States—without changing the productivity factor. The firms saw this as an expropriation and began legal actions to recover the difference with respect to the old formula. These actions ultimately failed.

The privatization agreement led to other disagreements. The firms faced lost revenues because developments in technology were presenting users with the possibility of finding alternative providers for the services for which the firms were charging the highest tariffs. Thus firms demanded tariff rebalancing. A series of public hearings was held to discuss the rebalancing, with the participation of different actors (the ombudsman, consumer groups, legislators) that opposed the measure. Aside from the fact that the rebalancing had sound economic justification and that it was clearly needed even before privatization, the important aspect was the contentious way in which the political and social agents interacted. After the rebalancing was approved, claims of illegality were filed in court. In some cases, the courts upheld, on procedural grounds, the claims of those who opposed rebalancing.

Following these legal decisions, the companies either stopped invoicing (in an attempt to delay billing until the legal claims had been resolved) or ignored the decisions and sent out invoices under the new tariff scheme. Both procedures were poorly received

by the public, which also perceived the regulatory agency as having been captured by the companies.³ Negative public opinion, aggravated by the regulator's inability to explain the reasons for the tariff rebalancing and regain credibility, influenced the position that other key agents adopted later in the conflict. The resolution to adjust tariffs issued by the ministry of economics in 1996 was never enforced because of political opposition. The issue was ultimately resolved by the president, and in 1997 the tariff rebalancing was approved by presidential decree.

These difficulties arose because the private companies had inherited an inadequate tariff structure from ENTEL. This resulted from the government's eagerness to initiate the reform process in public services as quickly as possible, to pave the way for reform in the other services sectors. The government was trying to capitalize on the period when it held a majority to introduce legal change. This was a reasonable stance, in view of Argentina's PMP, which offers few possibilities for inter-temporal cooperation between governmental and other political actors.⁴ The regulatory scheme adopted—which is characterized by the regulator's lack of independence and various technical and institutional deficiencies—should be understood as the result of the interaction between the special characteristics of the telecommunications sector and the institutions and practices of the national political game, in which short-term agendas often take priority over any inter-temporal agreement, leaving little room for long-term institutional development.

When Argentina ended exchange rate parity in 2002, deepening the economic recession, the contracts governing privatization of the companies would have allowed them to keep the tariffs unchanged in (indexed) dollar terms, which implied nearly three times their present value in pesos. Congress passed a law that repealed the contracts' dollar adjustment provision and prohibited any indexation based on the indices of other countries (or any other indexation mechanism), and set the tariffs in pesos, based on the old exchange rate of one peso per dollar. The law also authorized the executive to renegotiate contracts for provision of public services, setting up the Renegotiation Commission for Public Works and Services Contracts. As a result of these measures, the telecommunications sector fell into a deep crisis, various companies defaulted on their debt payments, and others shut down their operations.⁵

Public services policy in Argentina has been highly volatile. A policy of private sector participation in public service provision has been in effect for about 20 years without the development of regulatory institutions that are significantly independent of the political system. This has led, in some cases, to a degree of capture by the regulated companies. When the institutional design produced a more independent regulator (as in electricity and gas in the 1990s), capture did not occur. However, some decisions were made and actions taken that imposed financial losses on the private providers and thus amounted to some degree of expropriation. This was aggravated by the difficulty of settling complex cases through the judicial system. The political system was not willing to lose its discretionary capacity in regard to the sectors. Thus the regulatory institutions that were created in the privatization process were rapidly incorporated into the political sphere. This, in

³ Vispo (1999), cited in Celani (2000).

⁴ Spiller and Tommasi (2003).

⁵ See AHCJET (2003).

turn, resulted in limitations on their areas of responsibility, technical capacity, and financial resources. In this context, it is debatable whether the special agendas and political interests of the actors involved in the regulatory process had more influence on the decisions made (in rebalancing telecommunications tariffs, extending exclusivity periods, and delaying the introduction of competition, for example) than the broader public interest. The successive changes of government at the turn of the century produced a substantial policy shift. The situation moved from one of relative capture by the regulated companies to one of open conflict with the private providers (linked to the “pesification” of the contracts), making this a paradigmatic example of policy volatility.

The reforms of the 1990s profoundly changed Argentina’s PMP at the sectoral level. The key actors were now the privatized companies: mainly multinational firms with large amounts of capital in the sector at the international level. The regulatory agencies appeared as potentially important but institutionally weak actors with inadequate funding. Public opinion was initially favorable to the reform because of deficiencies in the existing provision of services. However, as the regulatory process developed, there was a widespread perception that the regulatory agencies had been captured, and that the regulatory process was providing important benefits to companies at the expense of consumers. This led to the appearance of actors such as the ombudsman, consumers’ associations, and even groups of legislators that opposed the way in which tariff problems were dealt with. The economic shock of 2002 was clearly unfavorable to investors, and it occurred at a time when the privatized companies were poorly perceived by the public. Against this backdrop, the response to the shock yielded important political benefits. Thus, in a political and institutional context largely unfavorable to inter-temporal agreements, the result has been public services policies characterized by substantial volatility.

Institutional Consistency and Stable Results: The Case of Chile

Chile has been a world pioneer in the introduction of various forms of privatization and the adoption of policies to promote competition in public services sectors. These policies have been based on an institutional framework that includes regulators with a high degree of technical capacity—although without a high degree of political independence—and an independent competition protection agency with a high level of involvement in sectoral policies. The policies have generally

Policymakers have come to recognize the limitations of direct regulation and the disciplinary power of market competition. This has led to a real transformation of policymaking in the area of public services.

been stable, benefiting from the economic stability of the country. However, they have exhibited some deficiencies in their ability to respond to shocks. The policies for each sector have been guided by technical objectives specific to that sector, as opposed to political considerations, and are consistent with fiscal policy. The institutional design and operation of regulatory institutions has effectively protected privatized companies from the risk of indirect expropriation, although at some cost in terms of efficiency, and in some cases giving rise to extraordinary profits.

Perhaps the best illustration of these characteristics is the reform of the telecommunications sector. In the mid-

1970s, telecommunications services in Chile were in the hands of two public companies. *Compañía de Telecomunicaciones de Chile* (CTC) provided local telephony to almost the entire country, while *Empresa Nacional de Telecomunicaciones* (ENTEL) offered domestic and international long-distance services. In the early 1980s, the market structure was changed radically. Both firms passed into private hands, and the first steps were taken to introduce competition into the sector. The regulation of telecommunications became the responsibility of the sub-secretariat of telecommunications (SUBTEL), attached to the ministry of transport and telecommunications. Its powers include design and regulation of sectoral policy, as well as the application of tariff-setting procedures. The Telecommunications Law of 1982 set guidelines for the development of the sector, establishing transparent processes for granting concessions, with exceptions made only on technical grounds (shortage of spectrum in mobile telephony). The law allows providers to set prices—except in cases in which the Antitrust Commission (established in the early 1970s) decides that there is insufficient competition. In these cases, prices are regulated.

In 1994, during the opening of the international telephony market to competition, there was a debate on whether the fixed-telephony operating companies should be allowed to operate in the international market. SUBTEL asked the Antitrust Commission for its opinion. The commission authorized the fixed-telephony firms' operation in that market, provided that before their entry, the government established a multi-carrier system, and the firms established separate independent companies to participate in the international market. In turn, SUBTEL established additional conditions for approving the application of the fixed-telephony firms to operate long-distance services. The pressures exerted by the firms on regulators to authorize vertical mergers, with a view to exploiting economies of scale, were dealt with by the Antitrust Commission. This prevented capture and favored solutions in which the integration of companies did not impede competition in the competitive segments of the market.

In the electricity sector, the privatization process began with the separation of regulatory activity from the public utility before 1980, at the same time as regulatory changes were introduced to allow private participation. Chile's three integrated public electricity companies were separated into multiple generating and distribution companies and then privatized, with the privatization taking place through the sale of shares in the new firms. Unlike in the telecommunications sector, the reforms did not impose vertical disaggregation on the companies, as the largest generator (*Endesa*) kept the property of the central electricity grid. Furthermore, generation and distribution companies were sold separately, but nothing prevented a generation company from buying a distribution company. This approach was criticized because it allowed the same business conglomerate to maintain a dominant market position by controlling large portions of all segments of the industry. The electricity sector privatization legislation left almost no room for the regulator to introduce more efficient solutions to problems that later arose that the legislation could not foresee or to resolve ambiguities in interpretation (on such issues as indices for tariff adjustment and setting of transmission tolls).

The technological characteristics of the electricity sector and the rigidity and ambiguities of the privatization legislation led to many conflicts related to the possibilities of vertical integration in the production stages and the (anti)competitive conduct of the

integrated companies. However, these conflicts made it clear that independent judicial intervention was able to prevent (indirect) expropriation of the privatized companies and that competition, as a principle embodied in the legislation, was deeply rooted in the working of the Antitrust Commission and the regulatory agency.

But even in Chile, there have been episodes in which politicization has played an important role. Regulatory action failed most clearly in response to the energy crisis of 1988–89. In those years, Chile was hit by a record drought, which led to the reduction of hydroelectric potential. In addition to its error in estimating the extent of the drought, the government did not impose restrictions on the use of water reserves until the last minute, having hesitated for fear of the political costs that such an unpopular measure would entail. The government's stance subjected the regulator, which was directly dependent on the government, to politicization—on an issue that was clearly technical in nature and had an obvious technical solution.

The regulatory decisions at the time of the crisis (to keep the cost assigned to unprovided energy low in spite of scarcity, to reduce the wholesale price of energy, and to refrain from establishing voluntary rationing quotas for unregulated large consumers) provided inadequate incentives for both producers and consumers. The legislature later passed a law establishing how energy rationing should be implemented. The law did not adhere to the principles of technical efficiency in managing the crisis, and instead introduced incentives that were harmful to the long-term development of the sector.⁶ The way in which the crisis was handled reflected the regulator's abandonment of technical solutions in favor of political considerations, with inefficient results. Strong politicization was clearly evident in this episode.

At the onset of privatization, Chile adopted a system of regulation by price caps. It includes a regular review of prices, based on a model that leaves very little room for discretion by the regulator. The price cap system involves setting prices based on a markup of profit over costs and capital in an efficient "ideal" model company with the capacity to meet the demand. Tariffs are set every five years and are indexed in the periods between adjustments. The utilities themselves carry out the tariff-setting studies and propose tariff adjustments, and the regulator comments on their proposals. The differences are submitted for arbitration to an expert committee. The regulator usually accepts the committee's decision, because the courts are generally disinclined to overrule the experts.⁷

Changes in the electricity distribution tariffs in 1992 and 1996, and those for the telephone companies in 1994, reveal that the processes for setting tariffs are extremely conflictive: the companies expended massive amounts of resources to influence decisions and used minor legal arguments to delay the tariff-setting process and negotiate an unjustifiably high tariff in response to their demands. They were able to attain returns of 20 to 40 percent, which are excessive considering the level of risk assumed. However, the gradual strengthening of regulatory institutions seems to be having a beneficial impact

⁶ Basañes, Saavedra, and Soto (1999).

⁷ Fischer and Serra (2002).

in relation to tariff-setting, as the margins have gradually declined to normal levels following the excesses that characterized the early years.

In the water and sanitation sector, the tariff-setting process followed the general scheme described above. In 2000, the first tariff review of the privatized companies led to a 20 percent increase in real terms. The tariff-setting system was clearly resistant to political pressures because, even in an election year, a significant increase was approved. However, the increase had a negative impact on public opinion in regard to privatization. It also influenced the policy adopted in subsequent privatizations of companies in this sector, in which, in contrast to the previous privatizations, a concession scheme was adopted instead of a sale of assets, given that the regulatory system in this sector was still too weak to regulate privatized companies adequately.⁸

In general, public services policy in Chile has been characterized by stability. The structural reforms in the direction of the privatization of public companies and the introduction of competition, which began during the dictatorship, have proceeded without major shifts. Developing competition has been a priority, and the privatizations of the 1990s avoided granting protected markets to the privatized firms. Consistent with these principles, the importance of the Antitrust Commission in the regulation of public services has grown over time, in line with its gradual institutional strengthening.

Regulatory agencies in Chile have considerably more human and economic resources than comparable agencies in the rest of the region, which has given them a higher level of technical competence. However, in terms of institutional setup and operation, they are no more independent of political influence than other agencies of their kind. So how can the stability of policy be explained? At least part of the answer is that the political-institutional system in Chile offers better possibilities for inter-temporal cooperation, particularly in a context in which preferences and ideological positions on privatization and the role of the market are less polarized than in other countries.

The results of the regulatory process have been varied. When protection of competition has been at stake, decisions have been consistent and stable. However, this has not been the case when the subject of the decision has been technically complex. For example, in the design of the operation of the electricity market, the regulator was subject to some capture by the regulated companies. In the case of the 1988–89 drought, its actions were influenced by fear of the political costs of a decision to ration use of limited water reserves. However, in cases in which regulatory intervention has been related to aspects of tariff-setting for monopolistic services, the dispute settlement mechanisms and judicial action have operated as effective institutional guarantees for the firms against the risks of expropriation by the regulator.

The reforms initiated in the early 1980s radically changed Chile's sectoral PMP. Public companies were replaced by private companies, regulatory agencies appeared on the scene, and the Antitrust Commission began to play a central role. The relationship between the new companies and public institutions has been dynamic, partly as a result of a gradual learning process in public institutions. The most important lesson learned in the regulatory field has been policymakers' recognition of the limitations of direct regulation and the disciplinary power of market competition. This has led to a real

⁸ Gómez-Lobo and Vargas (2002).

transformation of policymaking in the area of public services. The case illustrates how an environment characterized by strong and well-defined institutions and acceptance of competition can reduce room for discretionary policy decisions and limit the influence of special interests in such decisions.

Direct Democracy and Resistance to Privatization: The Case of Uruguay

Reforms have been limited because the potential losers have found mechanisms to block change.

Policies aimed at opening and modernizing the public services sectors have been unstable in Uruguay. In the last decade, the legislature has passed a series of reform-minded laws, which were then threatened by referendum or plebiscite, or repealed. The

impasse that this has created has not prevented progress in improving the functioning of public companies. Policies in this area have produced important fiscal benefits and have been very stable—mainly because the preferences of the public and the political system have aligned on keeping these companies public but improving their provision of services and are favorable to the companies.

Although the regulatory institutions created in the reform process lack adequate technical and economic resources, the bureaucracy of the public companies has been greatly strengthened, allowing them to operate more efficiently and effectively than is typical of this kind of company in developing countries. Moreover, their monopolistic power has been curbed in recent years by a series of legal decisions—despite the rigidity imposed by direct democracy mechanisms and popular resistance to measures that could weaken public companies.

Direct democracy is promoted in the current constitution, which offers a number of mechanisms that can be activated by citizens or lawmakers. Since the return of democracy in 1985, two mechanisms have been used. The first is referendum by popular initiative, which can block a law from being implemented if so approved by an absolute majority of the voters registered for that purpose (at least 25 percent of all registered voters). With only one exception—a referendum on amnesty for military personnel accused of violating human rights during the dictatorship—the procedure has been used exclusively to attempt to block laws related to public services (though not always successfully). A second procedure has been plebiscite by popular initiative. This mechanism can be initiated on the approval of as little as 10 percent of registered voters. Votes occur at the time of the national elections, and the mechanism can even be applied to amendments to the constitution. This procedure has been used for changes in the water and sanitation sector and in social security.

Direct democracy mechanisms for public services have all been promoted by the labor unions of the public companies affected. Political groups on the Left have also lent organized support and provided significant capacity for mobilizing voters (although in some cases with discordant opinions on the introduction of competition without privatization).

An important factor driving the reforms has been the desire to strengthen public companies as a source of public revenue. Unlike tax increases, adjustments to tariff rates

for public companies do not require legislative approval—an advantage for the government, especially in times of severe fiscal constraints. This apparent advantage, however, works against the objectives of reforming public services sectors.

Recent legislation has begun to break the monopolistic powers of State companies, with varying degrees of success. In 1997, the monopoly of *Administración Nacional de Usinas y Trasmisiones Eléctricas* (UTE) on electricity generation was eliminated. (Its monopoly on transmission and distribution was maintained.) In 2001, the monopoly held by *Administración Nacional de Telecomunicaciones* (ANTEL) on telecommunications activities was eliminated, with the exception of local and national long-distance telephony. This opened the way for the entry of competitors into international telephony markets, in addition to data transmission and mobile telephony. In 2002, congress repealed the 2001 legislation—in light of its imminent repeal by referendum. This prevented new competitors from entering international telephony markets. However, the companies that entered these markets while the legislation was in force continue to operate. In 2003, a law was passed to end the public monopoly on the refining and marketing of fossil fuels by 2006, and to open the way for the association of the State oil company, *Administración Nacional de Combustibles, Alcohol y Portland* (ANCAP), with the private sector. However, the law was repealed by referendum in late 2003.

The process of reforming public services in Uruguay has been relatively volatile. Many reforms passed by congress have been repealed by referendum. The ones that have escaped this fate (such as that involving the electricity sector) have suffered years of delay in their implementation, influenced by the political factors inherent in the public services sectors. Since the preferences of the population clearly incline toward public provision of services and the protection of public companies, opposition to reform attempts produces substantial political benefits. This makes it easier for unions to successfully promote direct democracy mechanisms. The preference for public ownership of utilities is widespread (although the need for competition in the public services markets is accepted). This preference can be traced to historical reasons (the strong presence of the State in the country's "golden era" in the mid-20th century), as well as the fact that the coverage and quality of services is not deficient, as it was in some other countries at the start of their privatization processes. Another factor working against the opening of services sectors to private investment has been the government's need for fiscal revenue from public companies. This factor has even led to delays in the implementation of legislation, introducing an additional element of volatility and uncertainty into those sectors.

Since reforms have not been very deep, the way public services policies are discussed and implemented in Uruguay has changed little. Public companies continue to be the key actors, with the broad support of the population. Reforms have been limited because the potential losers have found mechanisms to block change. The setting up of regulatory agencies has been the most important institutional advance toward establishing some level of market competition in the public services sectors, but little has been invested in strengthening these agencies technically, administratively, or financially. The agencies have some institutional independence, but face a fundamental limitation in that they do not regulate the tariff-setting of the monopolistic sectors (a power that remains with the executive). They also have limited ability to prevent anticompetitive conduct in a context in which public companies are vertically integrated and competition protection

agencies are limited. In addition, public companies have large and competent bureaucracies, with more capacity to affect political decisions than the regulator itself, and strong possibilities of delaying the implementation of decisions. The role played by the regulatory agencies in maintaining the main advances in liberalization should be emphasized, because there are no other key actors pushing in that direction.

Institutional Weakness and Attempts to Build Credibility: The Case of Peru

Because investors suffered direct and indirect expropriations in the 1980s, the main challenge facing public services policymaking in Peru in the last 15 years has been to generate credibility in a very weak institutional context. The outcome has been relatively successful, but at the cost of creating serious rigidities in sectoral policy. Although the policies promoted by successive administrations have consistently aimed to stabilize the

The case of Peru illustrates the difficulties confronting regulatory policy when there is a deficit of credibility in relation to investors.

policies for the sectors, in practice policy implementation has been volatile in view of the resistance by the legislature to most of the initiatives promoted by the current government.

With the arrival of the Fujimori administration in 1990, Peru introduced a sweeping reform program in the infrastructure sectors, based on the privatization of public companies in the telecommunications and energy sectors. This program was part of a strategy to remove the State from all business activities and stabilize the economy. The

reform program was the response of the government to a legacy of earlier nationalizations that had occurred without compensation (especially in the banking sector) and a variety of episodes of indirect expropriation, which had soured investors on investing in Peru.

To carry forward a privatization process in this adverse institutional environment, the government attempted to create credibility through a series of framework laws that offered greater legal certainty in regard to private investment, especially foreign investment. The laws introduced the possibility of signing legal stability agreements with foreign investors. These agreements, with the status of law, preclude the government from changing tax conditions, imposing labor obligations, or setting limits on companies' ability to transfer profits or capital out of the country. Thus, the government was willing to sacrifice its own powers to achieve credibility. It signed international investment protection agreements that allowed recourse to international arbitration bodies to settle disputes, as well as a series of bilateral investment protection agreements. If the domestic institutions for protection of investors were not sufficient, the government was willing to import such institutions when necessary.

To encourage private investment in public services, the Commission to Promote Private Concessions was set up, with responsibility for the partial or total sale of equity in public companies to the private sector. Regulatory agencies were also created for each sector (energy, telecommunications, water and sanitation, and transport), all of which were directly dependent on the executive branch.

The main characteristics of the reform process for public services are illustrated by the case of the electricity sector. Before privatization, electricity generation and distribution service in Peru was provided mainly by a single public utility, *Electroperú*. Distribution was provided by various public utilities, subsidiaries of *Electroperú*, including *Electrolima* (which also provided generation for the city of Lima). At the start of the reform, less than half of households had access to electricity, one of the lowest electrification rates in Latin America. Public companies produced 70 percent of the country's energy; industry self-generated the remaining 30 percent. Electricity tariffs were set at very low levels for political reasons, covering less than 40 percent of the operating costs of the sector. This was an enormous obstacle to the investment process. In 1992, the Electricity Concessions Law was passed, which separated the functions of generation and distribution, established a new tariff system, and authorized privatizations. Between 1993 and 1997, five generating utilities and five distribution utilities were privatized, with explicit commitments to increase generating capacity. With Peru's integrated electricity companies having been disaggregated by these privatizations, integration was prohibited as a procompetition measure, reinforced by the passage of the Electricity Sector Anti-Monopoly and Anti-Oligopoly Law.

Since the end of the final Fujimori administration in 2000, part of Peru's electricity sector has remained in the hands of public companies: the hydroelectric generating utility of the Mantaro basin and the distributors in the south of the country. State-owned *Electroperú* operates one-third of the country's generating capacity, while transmission is almost totally in private hands. The State is still an important operator in distribution, although the main distributors have been privatized. In the years following the privatizations in the electricity sector, installed generating capacity grew 25 percent, electrification coverage expanded 20 percent (30 percent, in privatized areas), and operating losses fell by 40 percent. In return, residential tariffs rose over 80 percent.⁹ Simultaneously with the privatizations, two institutions were created for sectoral regulation: the Organization for Supervision of Private Investment in Energy (OSINERG), and the Energy Tariffs Commission (CTE). These were later merged.

The country's main distributor, *Electrolima*, representing more than half of power distribution in the country, was split in two in 1993 and awarded as an indefinite-term concession, in the first major privatization of the Fujimori period. The concession agreements established the main aspects of the relationship between the privatized firms and the regulator, including tariff-setting and dispute settlement mechanisms.

Several points of contention left their mark on the regulatory system after the initiation of the privatization process in the electricity sector. One of them, between the regulator and the distribution firms in Lima, arose during the initial definition of tariffs in relation to the method for determining the replacement value of the firms' assets. The regulatory scheme adopted for the electricity sector used a cost-based tariff for the segments of the industry that were considered natural monopolies. An important part of the costs was associated with the fixed assets, which were valued at replacement cost for the purpose of the calculation. In 1997, the regulator published its estimates for the

⁹ Torero and Pascó-Font (2001).

new replacement value, which the companies strongly challenged in administrative and judicial bodies, and through a strong advertising and information campaign. The regulator maintained its position, with public support from the country's main political authorities, including President Fujimori, and the companies finally abandoned the litigation.¹⁰

Although the Electricity Sector Anti-Monopoly and Anti-Oligopoly Law prohibited concentration in different market segments and greatly limited integration of the industry, both horizontal and vertical concentration occurred in practice, as a result of mergers of business groups that controlled different firms in the electricity sector.¹¹ This obvious inconsistency between reality and rules was resolved by changing the rules—thus abandoning one of the central pillars of the regulatory system in favor of the special interests of investors. Affected sectors, such as business organizations, were notoriously absent from this process. And the political parties showed no interest, as if it were merely a technical discussion without economic and political implications.

The Toledo administration attempted to revive the reform process, which had lost momentum in the final years of the Fujimori administration. It promoted the privatization of two distribution utilities in Arequipa in the south of the country. Their sale was the subject of a constitutional appeal (*amparo*) filed by the mayor of the city of Arequipa, which claimed that the region, not the national government, was the owner of the distribution companies. A series of regional social groups organized around opposition to the privatization of the distribution companies. Popular demonstrations grew so large that they led to an indefinite general strike in the region, spilling over to neighboring areas, and the declaration of a state of emergency by the government. Finally, the government abandoned its intention to privatize the utilities and two ministers resigned. The demonstrations were led by local groups composed in some cases of *campesinos* and urban workers, but also including local chambers of commerce and even mayors.¹² The Mantaro generating complex, *Electroperú's* main asset, was also selected for privatization—until congress passed a law to abandon the plan, influenced by strong opposition to it.

The case of Peru shows the difficulties confronting regulation policy when there is a lack of credibility in relation to investors, and a shifting balance of power between the executive and legislative branches. To encourage private investment, it was crucial to offer broad guarantees. All relevant interests were aligned in support of this objective, and the legislature responded without objection, given its subordination to the executive during the first Fujimori administration.

Peru's experience with privatization altered the policymaking process in the public services sectors. Powerful private companies interested in exploiting potential monopolistic profits entered the market. Regulatory agencies also appeared on the scene, with a certain degree of operating independence and technical capacity, but under the control of the executive. Simultaneously, the balance of power of the executive vis-à-vis the

¹⁰ Campodónico (2000).

¹¹ Aguilar (2003).

¹² The area is among the places where President Toledo had the highest electoral support, and opposition to the privatizations was part of his election platform.

legislature changed. This was due in part to a fragmentation of the party system, which reduced the executive's chances of obtaining majority support in congress. The presumption of corruption surrounding the Fujimori privatization process further strengthened opposition to privatization and hindered efforts to continue the privatization process under the Toledo administration.

As circumstances changed, it also became clear that a regulatory agency dependent on the executive could not be isolated from politicization. Thus attempts to strengthen the credibility and stability of regulatory policy were frustrated because ultimately they were based on a circumstantial alignment of interests and on the temporary supremacy of the executive, rather than on a process of consensus-building and longer-term inter-temporal agreements among enduring political agents.

Conclusion

Policies in regard to and regulation of public services sectors are susceptible to politicization because of very high sunk costs, large economies of scale and scope, and mass consumption. These characteristics offer governments and politicians the possibility of behaving opportunistically to expropriate the provider companies—directly or indirectly—and take over their quasi-rents to benefit the Treasury or consumers. These characteristics also encourage firms to adopt monopolistic behavior, so they must be regulated to promote efficiency and protect the welfare of consumers. The risk of capture of the regulators by the regulated introduces further complexities into the public services sectors.

All regulatory agencies confront conflicting interests in the short term: not only between providers and consumers, but also between existing companies and potential new entrants, and among companies in the various segments of a sector (for example, between electricity generators and distributors). This makes the policymaking process for public services especially complex. It is influenced not only by the general policymaking process in the country, but also by complex institutional, political, and technical factors inherent in the sectors. As the process moves ahead and the economic and institutional structure of the market changes, public services reforms tend to alter policymaking in the affected sectors by introducing new agents into the process, by changing the balance of power among them, and by altering the possibilities for the relevant actors of reaching sustainable inter-temporal agreements.

The case of Argentina suggests that it is not possible to isolate public services policy from the more general policy context. In the absence of strong institutions that facilitate consensus-building and the forging of inter-temporal agreements, the regulation of public services is prone to volatility: sometimes favoring investors, and sometimes favoring the interests of politicians or consumers in the short term.

Chile has achieved stability in public services policy, thanks to the possibilities of cooperation offered by the political-institutional system. Such cooperation is further encouraged by low levels of polarization in preferences and ideological positions on privatization. This environment supports a system of public services that encourages not only the participation of private capital, but also competition in the provision of services.

In Uruguay, a certain convergence of preferences in favor of public companies, coupled with mechanisms of direct democracy that allow the electorate to express these preferences readily, has also lent stability to public services policies—although with a cost in efficiency. In spite of the difficulties of advancing reforms, legal decisions in some sectors have reduced the monopoly power of State companies in Uruguay.

The case of Peru is a convincing demonstration that the credibility required for good performance by public services sectors cannot be achieved overnight or imported. It must be built upon the foundation of a stable balance of power among the branches of government and backed by the technical competence and political and operational independence of the regulator, in tune with the perceptions and preferences of the majority of the population.