Comments

Gonzalo Castañeda: Most empirical studies on the effects of privatization deal with issues of profitability, labor productivity, firms' growth, and market valuation. McKenzie and Mookherjee's paper reviews four studies that analyze, instead, the impact of privatization on poverty and income distribution in several Latin American countries.

After warning the reader against making bold inferences from these studies given their data limitations, the authors tentatively conclude that the welfare implications of privatization (in terms of price, quantity, and quality) were favorable. Although employment contracted marginally in the short term, this impact seems to have disappeared in the medium term. All in all, the authors argue that the frequent disenchantment with the privatization process observed in different countries, as expressed by street demonstrations, is not consistent with the economic evidence provided by these studies.

The academic quality of this overview and the supporting papers is beyond any doubt. My comments here thus address their conclusions.

The authors attempt to explain the backlash against privatization policies based on political economy, such as the distribution of the effects and mobilization capacities of different groups, and on psychological factors. However, many economic policies, regardless of their socialist or neoliberal orientation, are formulated on ideological grounds that do not respond to the value systems and social norms in Latin American countries. The problems of imposing policies based on an alien ideology are twofold. First, they could have unintended economic consequences by modifying the rules of the game previously defined according to the country's underlying social structure. In other words, because informal institutions, or rules of social behavior, can be seen as equilibrium outcomes of metasocial games defined in the social structure of a society, formal institutions—such as laws—need to take into account the incentive system of the underlying social structure or social governance.[1] Second, although these policies could produce the policymakers' expected consequences, such as improving economic performance in terms of efficiency, profitability, and, perhaps, poverty alleviation, the final outcome may still be in contradiction with the existing value system and individual perceptions of what the socioeconomic life in a country ought to be. That is, a sense of lost traditions and identity might ensue in the community.

To clarify the first remark, I draw on the example of the privatization experience induced by the 1850s liberal reforms in Mexico. According to liberal principles then in vogue, special privileges, or *fueros*, for different corporations, such as the aristocracy, military, church, and Indian village, did not fit with the premise that the people and the nation should be composed by individuals who would interact in a legal framework with equal duties and rights. Legal reforms were therefore undertaken to discourage the survival of all collective actors in the prevalent corporativist system. One of the main privatization policies was the disentitlement of *ejidos* (land for common pasture and cultivation) and rural property in the Indian villages. However, that policy did not create the incentives for Indians to incorporate themselves and their land in a dynamic market economy.

In the traditional Mexican society, individuals were bonded together through ties that derived, to a certain extent, from their social conditions at birth, including their membership in ethnic and religious groups and their belonging to a certain community, geographical area, and socioeconomic strata. Furthermore, even when individuals voluntarily chose to establish business, social, and political links, they did so within an already defined value system and prespecified social customs. The liberal intelligentsia considered that these attributes of social life were "the" explanation for Mexican backwardness and that all links deriving from tradition constituted a form of serfdom that constrained individual potential. They therefore sought to release Mexicans from their attachment to their collective actors.

Under the Mexican social governance of the period, social customs disregarded the benefits of individual property rights on land, and thus Indian

1. Durlauf defines social governance as a set of mechanisms that influences individuals' behavior because of their membership in specific social networks and communities. See Steven N. Durlauf, "The Case 'against' Social Capital," University of Wisconsin, Department of Economics (www.ssc.wisc.edu/econ/archive/authord [1999]).

settlers did not take advantage of the policy of disentitlement. Even well-known liberals like José Luis Mora explained the Indians' lack of interest in individual ownership of their land as stemming from their preference for traditional patterns of tenure. Mora argued that "[the Indian] has never felt the sense of personal independence."[2] Instead, white colonizers were the main beneficiaries when the expansion of the railroad system created the incentives to encroach on Indian communal land. The seizure of Indian land was also encouraged after 1883, when Congress enacted the enclosure law. Through this legislation, private parties could obtain one-third of "vacant" land—that is, land without a title—when they performed the surveying and fencing tasks; the remaining two-thirds went to the government, which later resold the land to private interests. Therefore, land privatization did not build active labor and land markets, but rather created a system of dependence with almost no rights for the unprivileged.

This example demonstrates how populist policies framed within a liberal agenda can have deleterious effects on income and assets distribution. For one historian, the liberal policies of the mid-nineteenth century were "a tragic example of how dogmatism—in this case the application of liberal dogma that envisioned equality between the Indians and hacienda owners—can be so twisted from its original purpose of helping the poor as to benefit the rich at the poor's expense."[3] Alien ideologies that do not evolve by interacting with the political and economic institutions of a particular country, but are merely transplanted into laws, will hardly be accepted into custom and tradition. This inertia makes policymaking a very difficult endeavor. Policies should respond to the equilibria of the social structure, rather than aiming for the construction of what lawmakers and elites consider to be a perfect world.[4] The result will be a better coordination of human behavior and improvements in efficiency. This assertion should not be interpreted as justifying a hands-off approach with respect to the status quo. Well-meaning policymakers can induce some

2. Cited in Armstrong (1989, p. 39).

3. Alba, cited in Armstrong (1989, p. 45).

4. Ponciano Arriaga, a liberal who participated in the Constitutional Convention, believed that imposing a liberal legal system on the Indian population was not adequate since a market culture was alien to their idiosyncrasy. Rather, their ways of interacting socially and their paternalistic heritage had to be taken into consideration. Arriaga argued that alternative legislation could be used to create incentives modifying existing social relations, so that autonomous individuals and market exchange could develop with the passing of time. See Armstrong (1989, pp. 41–42).

reconfiguration of social governance that could improve social welfare, while building on existing informal institutions. Consequently, the real debate is not whether institutions matter, which they certainly do, but how formal institutions will change the rules of the game for economic actors whose structure is fundamentally set in the social domain. When legal reform does not formalize the equilibrium outcome derived from a society's social interaction, it is important to analyze what effect the reform will have on socioeconomic actors embedded in a specific social structure. Legal reform copied from foreign codes is very likely to have a destabilizing effect on the equilibria of social interaction in the domestic domain.

With respect to the second remark, another example from Mexican history is illuminating. In an analysis of the political stability observed during the Porfirian regime (1876–1910), Guerra uses the idea of a legal fiction when detecting an inconsistency between reality and the theoretical equality of individuals, the concept of federalism, and the universal male suffrage stated in the 1857 Constitution.[5] The author argues that the Porfirian regime represented an equilibrium outcome resulting from the adaptation of liberal laws to the realities of the traditional society prevailing in Mexico. This explains why, since the times of Juárez and Lerdo de Tejada, Mexican constituents have consented when authorities "elected" people's representatives. This concept of representation follows an old Spanish neoscholastic tradition, whereby the Catholic kings and the Habsburgs exerted their power by divine design but with the aim of protecting the traditions set by the community. Kings were thus natural and legitimate representatives of the community. While the liberal Mexican constitution specified that individuals should have elected their own representatives, the accepted reality was that those representatives would be appointed with the objective of preserving the traditions of the community (either the state or the municipality). Guerra emphasizes the importance of the social domain when describing outcomes in the political domain, as seen in his criticism of the analysis made by some detractors of the Porfirian regime: "Are they ignoring the specificity of old social forms, which have their own rules of behavior (scales of sanctions and rewards, customary limits to the authority, solidarity ties among individuals)?"[6]

5. Guerra (1995, chap. 1).

6. Guerra (1995, p 36). The technocrats, known as *científicos*, who controlled very important cabinet posts since 1892 (for example, Limantour in the Secretaría de Hacienda), and who were fervent adherents to the positivist philosophy, were right on target when they

People are simply more comfortable when a policy is consistent with their social customs and value system. At the time, therefore, many Mexicans did not feel that the government was being intrusive when their representatives were in fact selected from the top. Similarly the recent privatization policies may have been rejected by a large segment of the Mexican—or Latin American—population not so much because of their economic consequences, but because people felt betrayed when these policies destroyed certain basic principles of social life. One such principle is that public utilities should be controlled by the state and the "nation" to avoid abuses of the "people" by the elite. Regardless of whether this concept is misconceived or lacking in a theoretical basis, it can become codified in the minds of individuals who have witnessed a series of events in which powerful private interests benefited to the detriment of the unprivileged. Moreover, in the case of the Mexican economy, the post-revolutionary governments clearly indoctrinated the population for many years through the official texts and curricula used in primary education, along with other forms of political propaganda. Consequently, the privatization of state-run enterprises meant for workers and other groups that important elements of social vindication were lost and, in the new economic structure, their social identity was put into question.

In brief, the neoliberal reforms—in particular, the privatization experiences in Latin America at the end of the twentieth century—illustrate that foreign ideologies or misconceived laws can have diametrically different effects from those initially intended (for example, the privatization of Mexican banks and highways). This result is a consequence of the synchronic linkages between the social domain and the political and economic arenas. Political and economic structures are the product of an incentive system supported by the community's social governance. Building efficient and fully accepted economic institutions will be very difficult if the social structure is not changed, especially if the institutions are inconsistent with the prevailing social governance. This line of reasoning helps to explain the paradoxical origins of crony capitalism observed in Latin America and East European economies after neoliberal reforms

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recognized that the liberal premises of the 1857 Constitution were based on a fiction. They emphasized the inconsistency between free suffrage and a society whose social customs did not follow democratic principles and held that a precondition to achieving liberty and progress was to establish a political regime more suitable to social reality.

were passed. In a crony-capitalist system, opportunities to do business are not based on changes in prices owing to free market forces, and entrepreneurial activities backed by the enforcement of property rights are not the engine of the economy. Instead, capital is accumulated by businessmen who take advantage of their privileged position in the social hierarchy and membership in networks that provide them access to relational assets.[7] Thus, the neoliberal and privatization policies were often more concerned with private sector production than with freedom, autonomy, and equitable rights.

Orthodox economists do not explicitly consider the role of culture as a causal factor for explaining why only certain formal institutions perform as intended, and they are not interested in dealing with individual perceptions of their social environment.[8] For the profession to be more successful in understanding economic phenomena and improving people's standard of living, a more eclectic view of socioeconomic relationships is required than that offered by pure neoclassical models. A feasible alternative for tackling this problem is to use a theory of rational choice with social embeddedness (RACSE). This theory retains a stance of rational choice, since a functionalist methodology is present at the level of the economic structure, but not so much in the underlying social structure. That is, while economic institutions and policies are designed intentionally for specific purposes, this is rarely the case for social structure. Individuals' economic actions have a social basis since social interactions condition actors' preferences and restrictions. These social interactions have different intricacies: affective relationships, historic traditions, and socially shared values. Moreover, as in any theory of rational choice, behavior and institutional change is explained in terms of individuals' decisions and strategic interactions, such that the theory is also consistent with the view of methodological individualism.[9]

7. A personal resource becomes a social resource or relational asset when individuals are linked directly or indirectly through social networks. These resources could have either a material base (money, property) or a symbolic meaning (prestige, status, membership). For more detail, see Lin (2001).

8. Culture is defined as the set of beliefs and social norms of the social structure.

9. This eclectic theory combines sociology, economics, and anthropology to study economic decisionmaking and evolution. The methodology builds on the theoretical work of Bowles (2003), Aoki (2001), Basu (2000), Platteau (2000), and Granovetter (1985), among others; it is presented in detail in Castañeda (2002). The theory aims to develop a consistent and rigorous approach in which sociocultural patterns condition means-ends relationships

The RACSE theory combines elements of rational choice, cultural systems, political economy, and institutional analysis. While socioeconomic actors follow incentives and do cost-benefit analysis (rational choice), they do so in a setting in which social norms and networks condition the apparatus of decisionmaking (institutional analysis). The economic structure is consistent with the political structure, and both are consistent with the power relationships within the social structure. The configuration of the latter determines the bargaining position of actors for the establishment of institutions and organizations (political economy). Such configurations are based on cultural principles that have emerged historically and were able to induce certain beliefs and practices through social pressure (cultural systems).

A theoretical analysis of the consequences of privatizing state-run enterprises based on the RACSE methodology must, first, define the underlying social governance and identify who would be the likely new owners when those firms are put up for sale. Depending on the outcome, it will be possible to infer probable consequences in terms of market competition, income distribution, and poverty alleviation—for example, Indians versus white settlers in the disentitlement of *ejido* land. Moreover, because the value system of a community might heavily weight the state ownership of certain firms, the decision to privatize might best be reconsidered in favor of modifying the corporate governance of state-run enterprises (for example, in terms of redefining board composition or accountability rules) to make them more efficient without losing their original ownership configuration. Although the study of the economics of happiness is still in its infancy, surveys and empirical analyses should be carried out to determine the subjective well-being of the individuals, in order to provide more information to policymakers.[10]

Jaime Saavedra: The paper starts and finishes with the following puzzle: the statistical evidence regarding the costs and benefits of privatization is in sharp contrast with public perceptions. The paper analyzes evidence on several aspects—namely, welfare, employment, wages, poverty, and

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in individuals' decisions, so that cultural explanations can have solid microeconomic foundations.

10. See Frey and Stutzer (2003) for a state-of-the-art paper on happiness and economic performance.

inequality—and finds that either the direction of change is in the right direction or there is no effect from the privatizations. Overall, the authors find that privatizations had a positive effect, and the only area displaying somewhat weak evidence of a negative effect is employment. The authors therefore conclude that there is no convincing explanation of why people in Latin America are so disappointed with privatizations. The issue is extremely important, as implementation and regulation problems are making privatizations and concessions less popular with the public and with policymakers, despite its crucial role in allowing an increase in private investment in infrastructure and public services.

Prices and Welfare

Price regulation is probably the most important aspect of privatization that may affect welfare changes. The paper's analysis is based on household surveys, and the authors have to rely on two specific points in time for which data are available. Unfortunately, these data constraints force them to use two surveys that in most cases are well before and after the privatization. In the case of Argentina, the authors conclude that there were positive welfare effects because prices fell between the earlier survey (1986) and the post-privatization survey (1997). However, a large part of that fall in prices was observed before the privatization, particularly in the case of electricity. After 1993, prices actually increased (at least according to the data presented in the paper). This is a crucial point, as Argentina is one of the most deregulated markets in the region, and its privatization process is subject to heavy criticism. In the case of telephones, prices fell right after the privatization, but then they increased. It is thus not clear that the welfare gains may be attributed to privatization, at least in Argentina. Moreover, the post-privatization price increases suggest that the authors are measuring not only the effects of privatization, but also the effects of the performance of the regulatory agency.

Another point that should be discussed is the post-privatization welfare effect stemming from the recomposition of consumption within the telecommunications household budget induced by the large changes in the relative prices of the different types of telecommunications services (so-called tariff rebalancing). This may make some consumers better off and others worse off. The problem is that owing to data constraints, the authors use data for total expenditure in the service, and they cannot assess the impact of changes in welfare stemming from price reductions of the different types of service. This is particularly important in the case of telephones, where shifts in consumption patterns among local, long distance, and cellular phones may be quite large.

In the case of Bolivia, water tariffs increased. In the authors' calculations, the only favorable scenario in which welfare rises is when all increases in access are assumed to be related to privatization. This is unlikely here since only one municipal firm was privatized in La Paz. In Cochabamba, the privatization actually failed.

In the case of Nicaragua, private participation has been allowed since 1997, so it is not clear whether households that gained access to electricity between 1993 and 1998 (the survey years) did so as a result of the liberalization process. By 1997 there was only one independent generator selling less than 7 percent of the total dispatched in the country to the dominant public enterprise, ENEL. Moreover, large increases in welfare are observed in Nicaragua among households that gained access, for which budget shares have probably increased significantly. How prices are regulated for those households after 1997 is crucial for understanding public perceptions of privatization.

With the right data, this analysis of welfare changes holds promise as a component of a study of the impact on distribution using Gini coefficients and poverty indices, as changes at the macroeconomic level are generally small. However, the analysis presented does not allow one to make a clear assessment of the impact over welfare.

The Issue of Perceptions

Why are people upset with privatizations? My view is that consumers may be upset with regulators if they have not been able to set and enforce reasonable prices or to design appropriate consumption plans tailored to the heterogeneity of consumers. One avenue that could help to explain the negative perception among consumers is modeling a consumer's utility function to exhibit habit formation, where utility depends not only on the level of current consumption, but also on the change in consumption. Before the privatization of utilities, some households were not able to pay the access fee required to obtain a certain service (telephone service, for instance). In most cases, privatization reduced these access fees, and the service became available for these households. These households increased their level of utility because of both the higher level and the positive change in consumption. As the price of the service increases postprivatization, however, there is a drop in utility that is now reinforced by the "change in consumption" variable of the utility function. So in any privatization that resulted in an increase in access, the households would get used to having the service and later, as prices rise, might perceive that they are worse off by the whole process.

The negative public perception of privatization may be related to the unfortunate way the public policy discussion has been shaped. The question has been whether privatization is good or bad. The right approach was probably to ask who benefits and who loses from the change in model, as well as whether the regulators are doing their job. Unfortunately, tackling these questions will require much more precise data than what the paper offers.

Employment

As a result of the privatization process, some people lost high-quality jobs paying salaries that were probably above marginal productivity. Workers in public utilities were collecting rents which were impossible to replicate in a competitive labor market.[1] Such "personal tragedies" may affect public opinion on privatization, but it is unlikely that they could have counteracted the effect related to consumer welfare gains.

The available data are far from the best for this analysis, however. In the case of Argentina, the negative impacts found in the paper rely on the strong assumption that all laid-off workers were not able to find another job and that nobody received any compensation. This analysis has to be complemented with administrative data or with some form of analysis that follows the laid-off workers after the privatization.

The authors mention that in the long run, employment effects are probably positive. However, the welfare implications of job losses are not straightforward even in the short run. Chong and López-de-Silanes find evidence of adverse selection, and in many cases the best workers, who

1. In fact, displaced workers from privatized firms tend to be older and have sector-specific human capital with low value in other sectors. Even if they are able to find jobs in firms that provide services to the now-private firm, the quality of those jobs (in terms of wage, social benefits, and hours worked) is usually lower.

have the best chances of finding another job, are those who leave.[2] More work has to be done in terms of following laid-off workers in order to assess welfare losses stemming from labor reallocations.

Final Comments

In their conclusion, the authors mention that price reductions are an important part of the story in terms of increasing welfare. In several of the cases presented, however, there is no convincing evidence in the paper that prices fell after the privatization (although they did between surveys). They actually increased in the case of electricity in Argentina, in water in Bolivia, and in electricity in all Bolivian cities except Cochabamba. Not much can be said about Nicaragua since the liberalization of the energy market was incipient in 1997. Overall, the paper does not provide a convincing view that welfare improved, despite the increase in access. Not much happened in the aggregate in poverty and inequality, but the initial effects on employment were negative and concentrated in vocal groups of the society, and prices continued increasing after privatization.[3] No wonder the privatizations are still unpopular. If this is the case, the unpopularity of privatization should be attributed to the inefficiency of the regulators, not to the privatization process itself.

It is very difficult to generalize the impact of privatization on welfare and inequality across countries and even within countries. The effect of privatization, in particular the privatization of public utilities, depends heavily on how each sector is regulated, and this may vary tremendously within a country. Probably the right question to ask is whether the model of a private provider and a public regulator is better in this specific sector in this specific country.

Privatization essentially implies changing the management of the firm from public managers, whose utility function may not be clearly aligned with that of current and future consumers, to private managers, who under the right supervision will be more efficient in running these firms. Consumer welfare will now depend on the private managers and the regulator. The clue to reconciling the difference between popular perceptions probably lies in the regulators' inability to ensure lower tariffs after privatization.

2. Chong and López-de-Silanes (2002).
3. See Birdsall and Nellis (2002); Estache, Foster, and Wodon (2002).

The authors acknowledge that the exercise is severely constrained by the data, and they have tried to "extract whatever inferences are possible from existing data sources." I totally agree with this statement, and a great deal of effort has been put into this project. However, it might have been better to concentrate on a few specific privatization cases and to invest resources in gathering new data instead of torturing these household surveys without mercy.

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