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Editor's Summary

The North American Free Trade Agreement (NAFTA) entered into force on January 1, 1994. It will be almost ten years old when this issue of *Economía* begins circulating. A decade is a short time for development economists, but an eternity for citizens and politicians. Evaluations of NAFTA's impact are unavoidable, even if the evidence is limited.

This volume presents two contributions to that large and difficult task. On the whole, their message is optimistic: NAFTA seems to have raised productivity in Mexico and furthered the convergence of incomes within North America. Yet there are many caveats to this general result.

The first paper, by William Easterly, Norbert Fiess, and Daniel Lederman, begins by acknowledging what the authors call the "big events, little time" problem—namely, the difficulty of disentangling the effects of NAFTA given the many large changes that have taken place in the Mexican economy over the last two decades (unilateral trade liberalization, wholesale privatization, macroeconomic stabilization, and the 1994–95 tequila crisis, to mention just four). Their answer is to attack the question from as many fronts as possible and then see whether the assorted bits of evidence amount to a more or less coherent story. The paper thus looks at micro- and macroeconomic data; it uses time series, cross-section, and panel econometrics; and it studies both cross-national and purely domestic data (the latter consisting of evidence across Mexican states).

Easterly, Fiess, and Lederman arrive at a subtle set of conclusions. They find that Mexico has been in a process of convergence since the late 1980s, when it opened its economy. The tequila crisis interrupted this process, but it did not derail it. In fact, convergence seems to have sped up after 1995. That is the good news. The bad news is that Mexico and the United States do not seem to be converging to the same per capita income. The long-run differential could be as large as 50 percent, the authors estimate.

Why might future Mexican incomes be only half those in the United States? The results in the paper point to lasting institutional differences. Both time series and cross-country estimates generate this result, which is consistent with much recent evidence on the role of institutions in growth. This raises the extremely important question of whether NAFTA has also contributed to improving institutions, as defenders of the agreement have claimed. The evidence is mixed. Different indexes of institutional quality improved for Mexico in the 1990s—but they rose even more for Chile and several Central American countries, none of which enjoyed the benefits of NAFTA. Moreover, much of Mexico's improvement seems to have occurred after 1999, suggesting it may have resulted more from democratization than from the trade agreement.

What about the effects of NAFTA on productivity? After all, much theoretical and empirical work shows that the evolution of total factor productivity (TFP) is a main driver of growth and of long-run income differentials. The paper by Easterly, Fiess, and Lederman tackles the issue, as does the second paper in this volume, by Ernesto López-Córdova. Easterly, Fiess, and Lederman look at U.S.-Mexico productivity differentials by industry and find that "the NAFTA period was associated with a significantly faster convergence in manufacturing TFP levels." López-Córdova, by contrast, looks at plant-level data to characterize the evolution of manufacturing productivity between 1993 and 2000. Using estimated sectoral production functions, he decomposes manufacturing TFP growth into its possible sources: resource reallocations within and across firms and within and across industries. A striking first result is that 70 percent of the reallocation gains are explained by increases in the output share of more productive industries; firm-level gains account for the remaining 30 percent; reallocation within industries has a negligible impact. A second important result is that industries with strong trade links account for almost all the productivity growth.

Trade seems to play a role in the process. Estimating the effects of trade policy on productivity is not easy, however, since endogeneity problems arise right away: does openness contribute to productivity, or is it that less productive firms receive more protection? Using instrumental variables estimation to sidestep this issue, López-Córdova finds that import competition increases plant productivity (both in levels and rates), and so does preferential access to the U.S. market. Merely exporting or using imported inputs, on the other hand, does not seem to increase productivity growth.

These results are in line with estimates from other papers, which use different data and techniques. In the words of discussant Alexander Monge-Naranjo, "almost all these findings are becoming stylized facts."

If the effects of trade policy are controversial, even more so are the effects of privatization. The next two papers in this issue of *Economía* focus on two kinds of experience with privatization: telecommunications in Peru and highways in several countries in Latin America. Peru stands out in the region for the vehemence of recent public opposition to privatization. In mid-2002, demonstrations and rioting led to the cancellation of the planned sale of two electricity companies in the southern city of Arequipa. Earlier protests in Bolivia led to the renationalization of the water company in Cochabamba in 2000. Opinion polls throughout the region tend to find the public is deeply skeptical of the benefits of privatization. This creates a conundrum for its advocates: privatization supposedly yields benefits for consumers, yet those very beneficiaries oppose it.

The paper by Máximo Torero, Enrique Schroth, and Alberto Pasco-Font addresses this question by studying the impact of telecommunications privatization in Peru on the welfare of urban consumers. Between 1994 (the year of privatization) and 1998, the number of telephone lines increased by 167 percent, and waiting times to obtain phone service were eliminated. The quality of service improved dramatically. Yet a 1999 poll showed that only 20 percent of the population approved of privatization, of which the telecommunications sector was the flagship.

The authors estimate the change in consumer surplus from privatization using data from a 1997 household panel collected specifically for this purpose. The aggregate figures reveal a large rise in this surplus and therefore in consumer welfare, derived mostly from increased access to the service. The figures tell a different story, however, when disaggregated by socioeconomic level. Consumers in the high and medium categories are clearly better off. For those in the low category, small gains began to materialize only after 1996, and for those in the very low category, welfare is currently below preprivatization levels. Since respondents in the bottom two categories make up the majority of those surveyed, public dissatisfaction no longer seems so paradoxical.

The reason for the differential effect across income groups is simple. Fixed monthly access charges increased sharply with privatization. This is the main cost of service for poor consumers who do not use their telephone a great deal; for them, the increase was not offset by the fall in per-minute

local or long-distance rates. The opposite is true of consumers who are better off, for whom fixed charges represent a small portion of total expenditure. Poor consumers were thus hit particularly hard. Naturally, they tend to be dissatisfied with privatization.

Imperfect regulation may also bear part of the blame in the Peruvian situation. Torero, Schroth, and Pasco-Font report that the price of long-distance calls is higher than in other South American countries. In the market for local calls, lack of adequate interconnection fees reportedly prevents effective competition. Peru is not unique in this respect. Complaints of lack of competition and ineffective regulation have cropped up throughout Latin America—ranging from electricity in Chile and telecommunications in Argentina to pension funds in El Salvador.

Regulatory problems have also plagued attempts to privatize highways in several countries of the region, claim Eduardo Engel, Ronald Fischer, and Alexander Galetovic in the fourth paper of this issue. The build, operate, and transfer (BOT) system was the rage in the 1990s. Governments would auction off the right to build some infrastructure—a road, a port, even a jail—granting the winner the right to operate the facility for a fixed period of time, after which ownership would revert to the state. To many, the system seemed like a panacea: much-needed projects would be built without a peso of scarce government money; facilities would be well-maintained by their private sector owners; Latin America's infrastructure deficit would soon be a thing of the past.

Alas, actual experience has been a great deal less sweet. Engel, Fischer, and Galetovic focus on the experience with privatizing highways in Argentina, Colombia, and Chile. They find a surge in highway construction, but fiscal problems remain: "private financing of new highways freed up fewer [public] resources than expected. In several cases, public funds were diverted to bail out franchise holders in financial trouble." These bailouts were often carried out with little transparency and accountability. Other benefits from privatization sometimes failed to materialize. Projects with large political payoffs but low rates of social return have been built; budgets have been padded and renegotiated, increasing costs to consumers and taxpayers; and a handful of franchise holders have gone bankrupt, leaving projects unfinished.

The authors identify two reasons for these failures. The key problem is that countries followed an approach of "privatize first, regulate later." Regulation has been haphazard and lax. National arrangements have a

flawed governance structure: the same agency that designs and auctions the projects (and gets the political payoff when they are swiftly constructed) is in charge of regulation and supervision. Surprise, surprise: firms asking for a better deal ex post often seem to get what they demand from the regulator.

Engel, Fischer, and Galetovic also argue that most franchises were misdesigned. Fixed-term franchises (by far the most commonly used) force firms to bear the brunt of undiversifiable demand risk. This creates big incentives for them to renegotiate the contract if things do not turn out according to plan. The authors, in line with their previous theoretical work, maintain that the alternative of present-value-of-revenue (PVR) franchises is better: under that system, firms bid over PVRs, and the one offering the smallest amount wins the auction. Ex post, the term of the franchise adjusts exogenously to ensure the firm gets the revenue it bid for. Such auctions have been used in a few BOT projects, in Chile and elsewhere, but they remain relatively rare—a fact that discussant Juan-Pablo Montero finds puzzling.

Another controversial issue is labor market regulation, the subject of Gustavo Gonzaga's paper. The Brazilian labor market stands out for its strikingly high job and worker turnover rates. An average of 3.4 percent of formally employed workers begin or are separated from their jobs each month. Since a high turnover rate makes it unattractive for employers to provide training, this phenomenon could well reduce human capital and labor productivity in Brazil.

High turnover is not caused by some *carioca* eagerness to experiment and change but—argues Gonzaga—by misdesigned labor legislation. Brazil's severance payment system requires employers to deposit 8 percent of the monthly wage at an account in the employee's name at a state bank. So far so good. But here's the catch: state banks offer below-market rates of return, and workers can only get their hands on the money if they are fired without justification. The result is that workers and firms often negotiate fake dismissals, in which the worker gets fired (and compensates the firm for any firing penalties), withdraws his or her money from the state bank, and is then rehired. Each year there are 9 million withdrawals from severance payment accounts in Brazil.

One alternative might have been to reform the whole system, but the Brazilian congress did not choose it. Instead, it instituted higher firing costs in both the Constitution of 1998 and the labor law of 2001. The changes served to reduce turnover: a significant increase in average employment

duration was observed after both legislative changes. Yet the firing cost itself is a distortion with other costs. Gonzaga argues that a preferable policy might be to make returns on severance payment accounts an increasing function of employment tenure, so as to reward employees who hold on to their jobs.

Some final acknowledgments are in order. This seventh issue of *Economía* contains papers presented at the Panel Meeting held on 24–25 April 2003, in Santiago, Chile. The new Santiago office of the David Rockefeller Center for Latin American Studies at Harvard University cosponsored and graciously hosted the meeting. I am grateful to Steve Reifenberg, the Director of the Santiago office, and to Marcela Rentería and Alejandra Méndez for much help and support. Thanks are also due close to home: to the Associate Editors of *Economía*, the members of the panel, Managing Editor Magdalena Balcells, and Administrative Assistant Avedis Koutoujian. This issue of the journal benefited tremendously from their hard work.