The Status of Infrastructure Reform in Latin America

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THE STATUS OF INFRASTRUCTURE REFORM IN LATIN AMERICA

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Any assessment of the state of infrastructure reform in the region needs to begin with the experiences of privatization. In many respects, Latin America was at the vanguard of these reforms in the early 1990s, providing exciting opportunities to the private sector in telecoms, energy, and ports as well as some well publicized water concessions. Looked at in 2004, the picture has changed markedly and the state of infrastructure at this moment is not good. This note briefly examines the problem, why we got there, and why a realignment is crucial for region’s future.

THE CURRENT CRISIS OF CONFIDENCE SURROUNDING PRIVATIZATION

It is well known that public opposition to privatization has been growing in Latin America. The proportion of the population that believes that privatization has been beneficial declined from 45 percent to 25 percent between 1998 and 2002 according to surveys conducted by Latinobarometro. Understandably, support is lowest in Argentina, where only 15 percent now support privatization, although Argentina had posted the most consistent gains during the 1990s in terms of increased access and improved service for some basic utilities. Recent public opposition to new privatization attempts has thwarted those projects in Ecuador, Paraguay and Peru. Most dramatically, in Bolivia the public’s opposition to natural gas exploitation involving the private sector may have doomed a project whose returns would substantially have improved the economic fortunes of a very poor country.

How did we arrive at this point, especially since much of the academic evidence clearly shows that the gains from privatization outweigh the costs? The benefits of private sector participation in the provision of infrastructure services range from improved access, both the previously unserved as well those whose services improve in quality and reliability (see Leipziger, Estache, and Gomez-Lobo, 2001) as well as improved welfare in many cases. Consider, for example, the evidence presented by Galiani et. al., (2002) who demonstrate that those Argentine provinces benefiting from privatized companies that provided improved quality water exhibited lower incidences of water-borne diseases. In a much more far-reaching analysis, McKenzie and Moookerjee (2002) find that welfare as measured by a combination of access and affordability improved in the majority of cases studied of previously publicly-provided and subsequent private provision of service. Reports by WIDER in Ugaz and Waddams Price (2003) show that gains from privatized water in terms of new connections largely benefited the first and second quintiles of the

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income distribution, i.e., more than half of the newly connected in Argentina, Bolivia and Chile were in the lowest 40 percent of income-earners.

This evidence contrasts sharply with perceptions that privatizations raise prices, create unemployment and fail to benefit the poor. How can these disparate views be reconciled? In terms of public perceptions, it is no doubt true that the previously underserved are not the ones complaining, since there is ample evidence, for example in the case of water, that the unconnected pay much more for water informally purchased than when they are connected to the water line (see T. Solo 2003). There is also no doubt that in the short-run there will be employment displacement when inefficient public companies are replaced with profit-motivated firms. As shown by Chisari, et.al., (1999), however, when viewed in a general equilibrium sense, namely, once the full benefits of privatization play out, the benefits exceed the transitory costs.

There is also no doubt that the benefits of privatization in Latin America, in terms of public assets sold, have often been disproportionately captured by the Ministries of Finance to cover current budgetary deficits rather having been invested for further improvements in the sector. Work by Leipziger and Foster (2002) estimates that about 60 percent of privatization proceeds were used for current budgetary needs during the 1990s in Latin America. These were funds that could more wisely have been used to subsidize water connections, shelter price increases for poorer consumers, or finance rural electrification extensions to uneconomic areas. It is also undoubtedly true that governments have been ineffective in presenting the benefits of privatization in a fashion that the public can understand and believe. Such a task is often made more difficult by the politicized nature of debates surrounding privatization and the need for reform-minded administrations to act quickly to seize the political opportunity to deal with entrenched public monopolies. And lastly, expectations of private providers far exceed those for public providers, to wit when was the last known demonstration against a public monopoly!

The opposition to privatization may also reflect to some extent a broader ideological shift in the region. There is a widespread questioning of the Washington Consensus as a whole, of which privatization is seen as emblematic. Therefore, it behooves reformers to prove that they can deliver on the benefits of reform and not to expect that these will be taken for granted. Special efforts are needed to show the transparency of transactions, the fairness of reform, and most importantly, the actual benefits among stakeholders. If this is not done, projects like Bolivia gas exploitation will be stymied, public opposition to tariff increases in energy will drive private operators out to the detriment of service standards, and needed private investment will falter at a time when Latin America needs both to improve its competitiveness and provide vital services to broad segments of the population that are currently underserved.
THE MAGNITUDE OF INFRASTRUCTURE DEFICITS IN LATIN AMERICA

The current situation of Latin America’s poor is desperate as the proportion of people living below the poverty line has not changed from two decades ago, standing at about 35 percent. Underlying this dismal statistic is the fact that 75 million people lack access to potable water and 115 million live without adequate sanitation and 55 million without electricity. When adding in the needs for shelter as well as affordable and reliable transport to job sites, schools and health facilities, one sees a region whose infrastructure has not progressed in relation to regions such as East Asia, even less so vis-a-vis OECD standards (see Figure 1).

Figure 1

LAC now lags behind in roads, power and telephone

- In the 1980s LAC had more roads, electricity generating capacity and telephones per worker than the East Asian tigers
- By 2000, this was reversed – the gap with the Asian tigers and the OECD has now widened

Infrastructure deficits in Latin America are at the core of the region’s poverty problem. The work of Estache, Foster, and Wodon (2002) clearly shows the problems of both access and affordability for basic services. Whereas other regions, notably East Asia, invested heavily in social overhead capital (terminology from Korea) and worried about distribution of service access and delivery (e.g., Malaysia, Thailand), Latin America has ended up spending more on so-called safety net expenditures that Asia considered second generation social priorities.¹ The inequality of access to basic services in Latin America can also been seen in the context of the social compact or lack thereof that has created political economy strains in the region and has led to regime changes in Brazil, Argentina, Ecuador, Venezuela and Peru based on the promise of greater equality.

¹ See Leipziger 1997 on the development strategies of various East Asian economies.
This pattern reflects a generalized decline in public spending on infrastructure in Latin America since 1980. According to Calderon, Easterly and Serven (2003 a), public investment in infrastructure fell in all major economies of the region except Colombia between 1980 and 1998, and in most cases the amount of consolidated spending on infrastructure had reached less than one percent of GDP by 1998. This trend did not reverse itself during the recessionary years that followed in the region. When adding in the impact of private investment, Calderon, Easterly and Serven find that the total amount invested in infrastructure did not exceed 2 percent of GDP in 1990s anywhere except Chile and Colombia. Recent events concerning investment flows lead to the conclusion, especially in Brazil, Argentina and Colombia, that the lack of investment in the Region has now reached the point that depreciation far exceeds investment and that as a result Latin America’s capital stock is declining.

Figure 2

As is seen in Figure 2 private investment exhibits a secular increase (especially when divestiture payments are included) until 1998 and then shows a steady decline that brings total flows back to levels experienced in 1990 in the region. Major flows were destined for the largest countries in the region, namely, Mexico, Brazil and Argentina; moreover, they favored certain sectors like telecoms and energy. This reality re-enforces the point that even in the best of circumstances the private sector could only have been expected to cover the investment needs in telecoms and that the public sector’s role in the provision of basic services was always going to remain large. On this point, see Figure 3 which
indicates the hypothetical share of annual investment requirements that the private sector provided in its peak year of investment, 1998. Work by Fay (2000) and Fay and Yepes (2003) reveals that the needs for public investment far outstrip the fiscal capacity of most Latin countries.

Figure 3

At its peak, PPI could cover only a fraction of LAC’s infrastructure investment needs

"Investment needs" are from Fay (2000) adjusted to include rehabilitation and, for telecom, mobile lines. "Actual private investment" are from PPIAF. "All infrastructure" includes gas, ports airports for private funding, but not for overall need, which is therefore likely to be somewhat higher than $72 billion.

CRISIS IN INFRASTRUCTURE FINANCING

The observation that there is a crisis in the supply of infrastructure financing is easily demonstrated when looking a the data in Figure 2 concerning private flows and the data of Serven and Calderon (2004 forthcoming) that builds on their previous work and shows the sharp decline in public spending that ha continued since 1998. Part of their explanation for the earlier decline was that fiscal compression in Latin America fell disproportionately on infrastructure (see Calderon et. al., 2003 b), but that explanation does not explain the failure to cover investment needs over a decade.

A view currently gaining credence is that the fiscal stance of Latin American countries, while appropriate to keep historically troubling inflation under control, has, in fact, been inadequate to maintain the region’s capital stock in tact, much less expand services to the poor. The issue may well revolve around the structure of the fiscal accounts insofar as many countries see the bulk of the expenditures destined for interest payments on debt,
pensions, revenue-sharing, and at times poorly targeted social expenditures. Many expenditure categories are constitutionally mandated and the overall fiscal stances, while appropriate in a short-term economic management sense, may be inadequate to maintain longer-term growth. New work by Blanchard and Giavazzi (2003) and others points to the need to distinguish between recurrent and capital expenditures and to reconsider how capital expenditures are treated in a fiscal accounting sense.

This issue is of substantial importance in the context of public-private provision of basic services since the public sector’s ability to provide complementary investments is essential to “crowd in” private investments. Toll roads that lack access roads will tend to under-perform in terms of ridership and revenues, thereby placing a possible contingent financial liability on the public sector. Alternatively, the public sector’s ability to provide the subsidized water connection for poor households may have a large impact on the political acceptability of water concessions. The argument can also be made that a well targeted subsidy in terms of water access, for example, can have higher social benefits in terms of health indicators than alternative expenditures. There are many reasons to argue that properly targeted infrastructure expenditures have much to offer in terms of welfare improvements for the poor (see Leipziger et. al., 2003).

The inability of the public budget to finance infrastructure also hampers the economy’s competitiveness as seen in the much higher logistics costs in some Latin American countries where inventory levels are 2-5 times the levels seen in OECD countries (see Guasch et. al., 2002). The levels of infrastructure are strongly associated with trade performance, especially exports as seen by the work of Dollar and et. al., 2003. He shows that were Latin America to have the infrastructure levels of Shanghai, it would increase the potential export share of lives by 20 percentage points in Brazil and 12-13 percentage points in Honduras and Peru. Of course, many other policy changes would also be needed, but the basic fact is that Latin America lags East Asia, the world’s most dynamic region, and that this gap is widening. Without a serious commitment to increasing investment, Latin America’s growth will never reach the levels necessary to reduce poverty in a significant way.

TOWARDS A NEW APPROACH

In an attempt to promote new thinking on the subject of privatization, the World Bank’s Latin America and Caribbean Region Infrastructure and Finance Department sponsored a “Rethinking Privatization” workshop involving critics as well as academics and

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2 Findings from 43 developing countries, broken down by wealth quintiles shows that access to piped water is a key determinant of child mortality, explaining about a quarter of the difference in infant mortality between the poorest and the richest quintile, and 37% of the difference in child mortality. See Leipziger, Fay, Wodon and Yepes, 2003

3 It is interesting to note that had Latin America exhibited the growth rates of East Asia over the course of the 1986-2002 period, the Region’s poverty rate would have been half of what it is today; if one were to have improved the distribution of income, gains in poverty reduction would have come sooner. See Leipziger, 2001 and Bourguignon and Ferreira 2002.
policymakers in Washington in month of 2002. An interesting finding in an internal poll conducted prior to the workshop among infrastructure professionals in the Bank was that the percentage convinced that privatization would most likely produce positive results had fallen in the last 5 years. The poll stressed the need for institutional changes, in regulation and in efforts to see the benefits of privatization more broadly shared. Most professionals in multilateral organizations would likely take the view that a menu of policy options would be preferable, given the wide disparity of experience and the heavy weight given to experiments that failed. Nevertheless, the status quo is unacceptable in light of the access patterns already presented and the status quo ante (i.e., the situation of the 1980s in which consumers waited for years for land phone lines and saw no improvement in access to electricity) is equally unacceptable. Hence the need for positive momentum in the public-private dialogue, an issue admittedly not new but now of greater urgency in light of both public and private sector retrenchments.4

**Challenges for Governments:** The challenges for governments and their advisors include the need to improve the distribution of benefits from privatization, to strengthen regulation, and to find effective interventions in the many areas of policy that are not amenable to private sector solutions. They must also realize that the public’s opinion of privatization cannot be left only to the critics; it requires public communications strategies prior to and during the process of reforms. And finally it requires transparency of transactions and institutions that can maintain the public trust.

On the issue of distribution, there is a significant consensus about what this entails. It includes: a) ensuring that distributional issues are taken into account in the earliest stages of transaction design; b) paying greater attention to the transparency of transactions and most importantly to the use of privatization proceeds; c) safeguarding social objectives through well designed subsidies for the poorest; and d) improving communication with the public about the need for and the consequences of reforms. Many of these points are inconsistent with a political decision to privatize to meet a short-term financial need.

On the issue of proper regulatory processes, the analogy to capital market opening in the absence of adequate financial regulations and banking supervision is perhaps useful. While we still have much to learn about creating sound regulatory institutions, what we do know is that this aspect cannot be deferred. The fact that 80 percent of all concession contracts in Latin America were renegotiated within 4 years of their signing (see Guasch, 2003) should give one pause that a contract is the beginning not the end of a process and that proper regulation is essential for the long-term life of any such public-private arrangement. Greater attention to twinning arrangements between regulators, the use of expert panels and externally credible solutions to disputes, and procedures to de-politicize contract disputes can only help to create a better environment for the private sector to operate.

And finally, since privatization or other private sector involvement will only be economically viable is some sectors under some circumstances, governments should be under no illusion that PPI (private provision of infrastructure) is a panacea. As

4 For previous treatments of the issue see Dailami and Klein, 1998 as well as Basanes et. al., 1999.
previously mentioned, the need to create sufficient fiscal space to both invest in the infrastructure needed to underpin growth and competitiveness (see Easterly et. al., 2003 on the robust relationship between infrastructure and growth) as well as the socially necessary access to basic services means that fiscal reforms are indispensable. Greater attention to tax collection and tax equity as well as socially responsible spending can enhance that public sector’s ability to meet its own national goals as well as negotiate more effectively with the private sector. The case of Chile is instructive in this sense (see Leipziger and Perry, 1999 as well as Hachette and Luders, 1993, among others).

Challenges for the Private Sector: Against this backdrop, the private sector faces the challenge of trying to sustain existing contracts and re-engaging in potentially profitable markets at a time when public opinion is decidedly against their involvement. Recent experiences in Argentina in particular do nothing to instill investor confidence in the sanctity of contracts or the ability to renegotiate them in cases of force majeure. Argentina was in many respects the pioneer in PPI and it attracted $40 billion of infrastructure investments during the 1990s. With utility tariffs essentially frozen in peso terms almost 2 years after a 70 percent devaluation and widespread defaults on contracts, a record amount of $10 billion in claims has been filed with ICSID (International Center for the Settlement of Investment Disputes). Thus, the situation now facing the private investor is far worse than the status quo ante 1990.

There is a need to overcome the stereotype of the greedy multinational, and to be fair, some firms have not always acted responsibly in the privatization process just as some countries have also not behaved well. The perception, however, is that the foreign firms have made excessive profits, often using mechanisms such as expensive management contract fees or expensive inter-firm loans among affiliates, or, in the worst cases, have subverted the process, either directly or by making investments into poor regulatory environments with expectations of later receiving favorable rulings. Initial research by Foster and Guasch (forthcoming) shows that profitability measured as returns on equity for PPIs in Latin America have been quite volatile and moderate. Results are quite sensitive to accounting practices, however, and if, for example, management fees charged to concessions by parent companies are counted as part of profits, the RORs change considerably.

Areas for the private sector to improve include their own corporate social responsibility, a better understanding of the beneficiaries of their service, stronger attention to the public sector commitments to contracts, and a better assessment of risk. On CSR there is a need to embrace a higher standard of doing business. Commentators such as Peter Gleick have proposed a code of practice for responsible privatizations, including greater consultation with civil society (see Gleick, et. al., 2002). On beneficiary analysis, some contracts, such as the Tucuman water concession or the Cochabamba water project, could be seen as clearly unviable in terms of tariff design. In other areas, the expectations of public funding were also unrealistic, leading to breach of contracts between governments who could not afford their investments and companies who refused to undertake their shares. In many contracts, seen ex post, the assessment of risk was unrealistic from the outset, leading to questions of why investors were interested in the first place.
CONCLUDING POINTS

It is clear that the status quo is unacceptable. From the vantage point of newly emerging economies, the linkages between infrastructure and growth are clearly understood. From the vantage point of poverty and the Millennium Development Goals embraced by the donor community, the linkage to basic infrastructure services is equally clear (see Leipziger, Fay, Wodon and Yepes, 2003). And finally as the rethinking of the Washington Consensus proceeds (see Birdsall and de la Torre, 2002, Kucynski and Williamson, 2003 and Leipziger, 2000), it is also abundantly clear that the social compact between governments and the populace requires a higher level of investment in basic infrastructure services.

The task is too big for the public sector to solve on its own, although it is up to governments to take the lead and open new opportunities for the private sector to invest. The needs and therefore the opportunities for the private sector are equally inviting, whether in energy and telecoms, the traditionally more profitable areas, or in toll roads, negative concession contracts for rural electrification or water provision, or even in management contracts for sanitation and solid waste disposal.

But what is needed is a resetting of the clock. The lessons of the past decade are not to ignore the risk factors or to delay the institutional requirements, but rather to accept the fact that contract design is imperfect and that regulation and renegotiation are part of the process. What can make it beneficial to all parties is the transparent and fair handling of these issues with the goal of providing better infrastructure services to a Region that desperately needs and will have to pay for them one way or the other.
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