

University of Oxford Centre for Brazilian Studies

Working Paper Series

Working Paper CBS-30-02

The Brazilian Privatization Experience:

What's Next?

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THE BRAZILIAN PRIVATIZATION EXPERIENCE: WHAT'S NEXT?¹

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Abstract

This paper analyses the process of privatisation in Brazil and argues that it was a pragmatic response to short-term macroeconomic problems arising from the state of disarray of national fiscal accounts. Privatisation was propelled by the fact that foreign ownership of infrastructure and basic input sectors ceased to be seen as a threat to “national security”, because of a shift in the focus of development policies towards efficiency and away from the mere accumulation of capital, and due to a close relationship between privatisation and macroeconomic policy. Of the three, the author attributes greatest weight to the macroeconomic policy connection. Hence the first curbs on SOE expansion in the mid-1970s, when the growth cycle started in the forties showed the first signs of exhaustion. Indeed, until very recently, failure to stabilize the economy and resume sustained growth served as the main motive for privatisation. The author attempts to show that privatisation in Brazil met the imperative needs of the stabilization effort, more than it resulted from an ideological conversion process (although these two were not the only motives).

¹ Paper presented at the workshop “Changing nature of business-state relations in Brazil: strategies of foreign and domestic capital”, Centre for Brazilian Studies, University of Oxford, January 28, 2002.

The author is grateful for helpful comments by Fabio Giambiagi.

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The paper then looks at the quality of regulation in public services after privatisation. A final section considers the question of how durable privatisation is likely to be in Brazil. In his view, future privatisation will depend on the role ascribed to the state in the policy framework of future governments and, the success of past privatisation in enlarging supply, reducing prices and improving service quality. To augment the stability and benefits of private ownership of former state enterprises, particularly in infrastructure, Brazil should strength regulatory institutions and reform capital markets, ensure competition in all infrastructure sectors, lighten the burden of regulation, not only for the usual arguments of asymmetric information, but also to compensate for institutional weakness.

The author also considers the possibility of the pendulum swinging back towards re-nationalisation. He argues that pragmatic privatisations risk being less durable than those that reflect profound changes in social views about the role of the state. The pendulum could swing back if regulation fails to encourage the levels of investment necessary to increase supply consistently with demand, generating shortages and harming consumers, default on loans extended by public banks, particularly in infrastructure, put former state owned enterprises back in the hands of the state, and if excessive protection to investors causes political costs to be higher than nationalization. However, in the author's view, while re-nationalization may be plausible, it is not likely in the short to medium term. Public savings should stay low for several years, which makes a sustained policy of high public investment difficult to pursue. Further, privatisation, like other reforms, creates a new status quo and set of interests that resist change.

Resumo

Este texto analisa o processo de privatização no Brasil. O autor argumenta que o processo constituiu uma resposta pragmática a problemas macro-econômicos de curto prazo resultantes da desordem das contas fiscais nacionais. A privatização foi ganhando terreno com o declínio da visão de segurança nacional que se opunha à transferência de infraestruturas e setores básicos a mãos estrangeiras privadas, com uma mudança a favor de políticas de desenvolvimento baseadas na eficiência em vez da mera acumulação de capital, e devido à relação próxima entre a privatização e a política macro-econômica. Destes três fatores, o autor atribui maior peso à ligação com a política macro-econômica. É por isso que os primeiros ataques à expansão das empresas estatais a meados dos anos 70 tiveram lugar quando o ciclo de crescimento dos anos 40 mostrou os primeiros sinais de exaustão. De fato, até à pouco tempo, a incapacidade de estabilizar a economia e de fomentar um crescimento sustentado, foram os motivos principais da privatização. O autor tenta demonstrar que a privatização no Brasil correspondeu à necessidade imperativa de estabilizar a economia, e menos a um processo de conversão ideológica (embora estes dois fatores não fossem as únicas motivações).

O texto analisa também a qualidade da regulação dos serviços públicos após a privatização. A parte final considera a questão da durabilidade da privatização no Brasil. Para o autor, o futuro da privatização dependerá do papel outorgado ao estado por futuros governos, e do aumento da oferta, redução de preços e da melhoria da qualidade de serviços ocasionados pelas privatizações já realizadas. O Brasil deverá aumentar a capacidade das entidades reguladoras e reformar os mercados de capitais, especialmente na área das infraestruturas e dos setores básicos, para aumentar a estabilidade e os benefícios da privatização de antigas empresas estatais. Deverá também assegurar o maior nível de concorrência possível entre os setores infraestruturais, aligeirar o peso da regulação, não apenas por causa da informação assimétrica, mas para compensar as debilidades institucionais.

O autor coloca a hipótese da re-nacionalização, considerando que as privatizações pragmáticas podem ser menos duradouras que aquelas que refletem uma profunda alteração da visão da sociedade do papel do estado. Poderia haver um retorno à nacionalização se a regulação não venha a encorajar o investimento necessário para aumentar a oferta consistentemente com a procura (gerando escassez e prejudicando os consumidores), se o não-pagamento de empréstimos concedidos por bancos públicos venha a colocar as antigas empresas estatais novamente em mãos do estado, especialmente na área das infraestruturas, e se um protecionismo excessivo dos investidores venha a provocar custos políticos mais altos que aqueles associados à nacionalização. Para o autor, no entanto, a re-nacionalização é pouco provável no curto e médio prazo. É provável que a poupança pública continue baixa durante os próximos anos, o que impede a implementação sustentada de uma política de investimento público. Por outro lado, tal como outras reformas a privatização estabelece um novo *status quo* e novos interesses que resistem a mudança.

1. Introduction

For political scientists, the many privatization efforts around the world in the last two decades can be grouped into three categories: systemic, tactical and pragmatic.³ Initiatives in the first group have deep, ample objectives, being intended to reshape economic and political institutions, as was the case in Chile, England and New Zealand. Tactical cases are those in which privatization is aimed at the short-term objectives of political actors, such as political parties and interest groups. Pragmatic privatization, in turn, tends to suffer less influence from ideology or politics, being only one of a number of alternatives the bureaucracy deems adequate to further social objectives.

It is not straightforward to say in which category Brazilian privatization fits best. Sprawling over the last 20 years, with total revenues of close to 83 billion dollars and almost 170 state owned enterprises transferred to the private sector, it is undeniable that privatization has substantially changed the country's economic and political landscapes. In 1996-98, in particular, when ports, railways, roads, telecommunications and electricity were transferred to private hands, the state substantially reduced its weight in the economy, allowing for the establishment of new national and foreign players, with deep implications for the way product, labor and political markets operate.

Yet, as we argued elsewhere (Pinheiro and Giambiagi, 2000), privatization in Brazil was above all a pragmatic response to short-term macroeconomic problems, arising mainly from the state of disarray of the country's fiscal accounts. It did not, in this sense, differ much from the process of nationalization of the economy in the post-World War II period, when state owned enterprises were seen as a means to boost investment in certain sectors. Ideology and the pursuit of structural adjustment were motivations espoused by only a fraction of those in charge of taking the process forward (Velasco, 1997a and b). In fact, many opinion polls showed that throughout these two decades a substantial share of the electorate opposed privatization. In many instances, the reason it was tolerated was the perception, correct in our view, that privatization was instrumental in achieving macroeconomic stability and allowing for a recovery in investment.

³ See, for instance, Scheneider (1990b) and Feigenbaum, Henig and Hamnett (1999).

Pragmatic privatizations, even when wide as was the case in Brazil, risk being less durable than those that reflect profound changes in society's view about the role of the state. Looking at privatizations worldwide, Feigenbaum, Henig and Hamnett (1999, p. 173) conclude that “[m]uch of what has occurred to date has been shaped by pragmatic and tactical motives, and ... may prove to be self-limiting, as the constituency for a backlash strengthens. The coalition that has carried out privatization forward is more diverse and disunited in motive and interest than the rhetoric of the privatization revolution acknowledges.” Velasco (1997a and b) makes a similar assessment for the Brazilian case, highlighting the underlying tensions in the coalition that has managed Brazilian privatization. In the same vein, Baer and McDonald (1998) note that in Brazil many of the sectors now being privatized were nationalized in the past, and stress the sensitivity of the *status quo* to volatile political mood, asking whether the future will see the pendulum swing back in the direction of an economic model with a strong presence of the state in the economy.

The object of this paper is this swinging pendulum. In particular, we analyze the forces that made it swing in the past, both towards greater state intervention and later in the direction of privatization. Building on this analysis, we discuss in which way we should expect the pendulum to move in the future. In section 2 we briefly review the reasons that led to the establishment of state-owned enterprises (SOEs) in several sectors of the Brazilian economy, and discuss the first movements in favor of privatization. In section 3 we argue that privatization in Brazil met the imperative needs of the stabilization effort, more than it resulted from an ideological conversion process (although these two were not the only motives). Section 4 discusses the quality of regulation in public services after privatization. A final section considers the question of how durable may we expect privatization to be in Brazil.

2. Nationalization and privatization in Brazil

State owned enterprises (SOEs) have existed in Brazil since colonial times, but state intervention in the economy, by creation of SOEs or

otherwise, was relatively small until Getúlio Vargas came to power in 1930. With the establishment of Vargas's New State (*Estado Novo*), the liberalism of Brazil's First Republic gave way to economic nationalism, protectionism, high public investments in infrastructure and basic input sectors, and the creation of public monopolies for products such as sugar, coffee, mate tea, etc. In the subsequent decades, SOE presence in the economy grew steadily, as the result of several different processes:

[1] Developmentism, especially the decision to install a diversified industrial sector in Brazil, with the creation of SOEs in areas in which the private sector lacked the interest or the financial muscle to invest. A typical case was steel. The same kind of motivation was behind public investments in infrastructure, as in highways.

[2] Concern for "national security", whose vague mantle covered three main areas: concerns with shortages of some important products during World War II; the desire to keep industries which were considered to be strategic under government control; and the decision to limit the participation of foreign companies in the Brazilian economy. Companies such as Fábrica Nacional de Motores, Álcalis, Lloyd, Serviço de Navegação da Bacia do Prata and Embraer were created, or nationalized, for this reason. Economic nationalism, as reflected in the concern to keep exploitation of the subsoil in Brazilian hands, determined the creation of both CVRD and Petrobrás, respectively the largest mining and oil companies in the country.

[3] Nationalization of foreign companies in areas in which regulation failed to attract the levels of investment required by Brazil's high economic growth. Examples were the railroad, communications and electricity sectors⁴. This movement, however, also met the needs of the "national security" argument, put forward by groups who feared control of these sectors by foreign companies.

[4] Regulatory failure of the opposite kind (i.e. excessive protection to investors) followed by nationalization. This occurred when, for force of contract, regulation obliged large transfers of public funds to foreign companies, a process that faced great political opposition. This was the case

⁴ For a recent discussion on this process in the electricity sector, see Baer and McDonald (1998).

of the railways nationalized in the late 19th and early 20th centuries. The problem then consisted of the creation of contingent fiscal liabilities through the concession of public guarantees of a minimum return to investors, with the state absorbing much of the risk involved in operating the concession.⁵

[5] Verticalization and diversification of the activities of large SOEs, motivated by the objectives of occupying “empty spaces”, a central element of the import substitution strategy, and of increasing SOE profitability, with the creation of subsidiaries in sectors with high rates of return. This process, facilitated by the high self-financing capacity of SOEs, led to a rapid rise in public sector participation in sectors such as pulp and paper, petrochemicals, aluminum, and transportation. The 1967 Administrative Reform (Decree-law 200) and the increase in SOE tariffs in the late sixties intensified this process, by giving those companies the freedom and means to expand.

[6] Nationalization of bankrupt companies – most of them large debtors of public banks -- operating in sectors which were naturally alien to public administration, such as hotels, sugar mills, publishing companies, etc. These firms subsequently showed a remarkable resistance to returning to private hands. Seventy-six of the 268 federal SOEs that existed in 1979 came under state control this way, compared to a total of 40 created by law.

There is no consensus in the literature as to whether the rapid growth of the Brazilian state sector was the result of an ideology of state intervention or whether it was caused by superimposed although disconnected movements. For several authors, although economic policy began to be more interventionist with the *Estado Novo*, the rapid post-war growth in the number of SOEs (there were only 20 federal SOEs in 1940) was not a planned phenomenon nor the result of a nationalizing ideology [Baer, Kerstenetzky

⁵ “To attract foreign capital in the 19th century the Brazilian government made use of legislation which guaranteed a minimum rate of return, ranging from 6 to 7%, for a period of 60 years. Railways and sugar processing plants were the sectors that most benefited from these incentives. The rate of return guarantee ‘... meant that a major difficulty faced by foreign capital invested in an economy outside the gold standard was partly circumvented, as the actual rate of return did not vary with fluctuations in the exchange rate.’ (Abreu, 1996, p. 9) Toward the end of the century these guarantees became a political and economic liability to the government, resulting in the gradual nationalization of the railways.”(Baer and McDonald, 1998, p. 505)

and Villela (1973); and Cardoso (1973)]⁶. For Martins (1977, pp. 26-27), however:

“...there was always an ideology of state intervention (whether in the form of *statism*, *nationalism*, or *developmentism*), in which the point of reference was the concept of the nation. (...) This was why, on the ideological plane, these three “isms” often appeared in an intermingled form, as interchangeable concepts (...). It is historically inexact, however, to state, as is now frequently stated, that the business activities of the state emerged in Brazil almost accidentally and without any link to any defined political project.”

Quite apart from this controversy, however, the rapid expansion of the state sector did not cause any significant concern before, at least, the end of the so-called “economic miracle”, which lasted from 1968 to 1973. In a paper written in the early seventies, Baer, Kerstenetzky and Villela (1973, p.281) asserted that:

“The continuous growth in the participation of the state in economic activities in Brazil in the last three decades was almost inevitable. The Brazilian private sector is still relatively small and does not have the capacity to play an important role in the country’s enormous needs for infrastructure or in the industries which use more sophisticated technology, which are also the most dynamic – petrochemicals, steel, transportation equipment, etc. Soon, the growth of the state will no longer be considered as a threat to Brazilian private companies.”

But like the “Brazilian miracle”, this harmonious coexistence between private and state capital was at the time already coming to an end. With the deterioration in economic conditions, and the decision of the government that took office in March 1974 to reduce the influence of the private sector in deciding how to allocate public savings, the first objections against the excessive state participation in the economy would soon arise. Eugênio Gudin, a known liberal elected Man of the Year by the magazine *Visão* in 1974, stated at the award ceremony: “We live, in principle, in a capitalist system. But Brazilian capitalism is more controlled by the state than in any other country, except for those under communist regimes.” Gudin’s speech was to be followed by a series of articles under the joint title “The Directions of Nationalization” [*Os Caminhos da Estatização*], published in early 1975 by the

⁶ Cardoso (1973, p.143), for example, argues that “[t]hat policy orientation [concentrated on strengthening the role of the state as investor], as has now been well documented, was more a short-

influential *O Estado de São Paulo* newspaper, and by the “Campaign against Nationalization”, mounted by private-sector businessmen⁷.

A proper reading of the businessmen’s arguments, however, shows that this was above all a movement against de-privatization, even if partial, of the state. Thus, the businessmen’s exclusion from decision making forums was a particularly important element behind their dissatisfaction – starting from the composition of the Economic Development Council (*Conselho de Desenvolvimento Econômico – CDE*), on which only the president and some ministers would have seats from 1974 onwards. In particular, private-sector businessmen wanted to be “heard throughout the whole process of decision on the national economy, helping to establish criteria for the activity of the state and the private sector, orienting the use of the SOEs and controlling their expansion, deciding directions for the investment of their savings, etc”. [Pessanha (1981, p. 154)] Among their principal suggestions to reverse the process of nationalization, Pessanha (1981, p. 95-96) mentions “the suppression of some privileges enjoyed by the public companies, such as the freedom to invest funds and exemption from some taxes, limitation of their capacity to create subsidiaries, through control of diversification, prohibition of use of funds arising from compulsory savings and other tax incentives”. The sale of SOEs, although mentioned, was accompanied by so many misgivings or doubts on its effectiveness and on the issue of in what sectors it could happen, that it finished up playing only a symbolic role in the overall body of

term response to practical problems than a coherent set of projections based on a nationalist ideology”.

⁷ Having in mind the success of the intervention strategy begun at the end of the 1930s, it was to be expected that continuation of this process, as provocatively imagined by Baer, Kerstenetzky and Villela (1973, p.282), would be a cause for concern by the Brazilian private-sector business community:

“The recent activities of gigantic companies such as Petrobrás and CVRD, entering into related sectors through the creation of subsidiaries, raises questions. Petrobrás, for example, is now expanding into several areas of petrochemicals. It would not be entirely impossible for Petrobrás, one day, to expand into overnight hotels, restaurants and/or food distribution establishments.”

the businessmen's proposals⁸. Privatization was not a priority for businessmen.⁹

The government's reply came in the proposal to strengthen national private companies through tax and credit subsidies¹⁰. On the issue of SOE privatization, Pessanha (1981, p.133) noted: "the reply contained in the document admits that it is clear that the return to the private sector 'should take place in the specific cases identified, to characterize a political orientation'. However, 'that is not where the essence of the problem is', since to assure a nationalizing trend for the country is to give 'strength and vitality' to Brazilian companies, 'which, above all, need capitalization', since the problem of 'empty spaces' is frequently 'an expression of the lack of risk funding in the hands of the national private sector'. But

'the transfer to the private sector of companies which – especially those in infrastructure (Petrobrás, Eletrobrás and its system, Telebrás and its system, CVRD, Usiminas, CSN, Cosipa, etc.) – are within the areas defined by the II National Development Plan (II PND) as being the public sector's social responsibility, has never been considered nor could be considered'."

To go beyond these measures was seen as contrary to the country's best interest. In other words, the government continued to perceive that it was urgent to industrialize the country, "occupying" sectors regarded as "strategic", and that while national private companies were not equipped to do so, it was not desirable, from the point of view of "national security", that this should be

⁸ Ironically, this was due, of all things, to the criticism of the for-profit nature of SOEs. As noted by Pessanha (1981, p. 84) "some SOEs are accused of, running in contrast to their goals (operating in pioneering and basic activities, but of low profitability and with a long time horizon for return), seeking operations in industry directed specifically at making a profit, such as the case of CVRD, which 'always refused to participate in doomed projects, which even recently occurred in the case of the Caraíba copper project in Bahia state' (O Estado de São Paulo, 3/22/75)".

⁹ In the businessmen's view, one of the reasons why privatization was not a solution was their lack of funds and the concentration of credit in public banks. In a document produced by business leaders, this issue is expressed as follows [Pessanha (1981, p.105)]: "Either the private-sector company acquires state-controlled companies from the government, '*with funds from the public sector itself*', an option which will make it extremely difficult to choose the new owners without falling into paternalism, or the already scarce funds of the private sector will be absorbed in buying existing undertakings, leading the government to fill up the newly-formed 'empty spaces' with these funds". Experience was later to show the importance of providing financing to domestic buyers to make privatization viable. This happened in the 1980s with financing from the BNDES (Brazilian Development Bank), and later through financial instruments created using "privatization currencies", and later still, once again through financing from the BNDES and even the Treasury itself.

¹⁰ The rationale behind this position was presented in the document "Action for Domestic Private-Sector Companies, the Government and the Market Economy", prepared by the Economic Development Council, and published on June 15, 1976.

done by foreign firms. Severo Gomes, then Trade and Industry Minister, commented at the occasion on the subject of the Campaign Against Nationalization, that “to privatize, today, would be to de-nationalize”. In the same vein, Mário Henrique Simonsen, the Finance Minister and a well-known liberal, remarked in response to Gudin’s statement that “any discussion on privatization will always be innocuous, if one is to leave empty spaces”. He added that the origin of the state company in Brazil was linked to the objective of “filling empty spaces”, and not to ideological motives [Pessanha (1981, p.122)].

At the end of the 1970s, the country’s macroeconomic situation again worsened, making control of inflation and external balance top priorities, to the detriment of short-term growth. The rapid expansion of the state business sector was inconsistent with the objective of stabilization, and even the idea of privatization began to permeate government discourse, although with a lack of practical consequence. In a message to his cabinet shortly after taking power, in March 1979, President Figueiredo recommended adoption of the measures necessary “for privatization of the SOEs and services that are not strictly essential to correction of market imperfections or for meeting the needs of national security” [Palatnik and Orenstein (1979, p.52)].

Still in 1979, the government decided to curb the growth of SOEs, with the creation of the National De-Bureaucratization Program and the Special Secretariat for Control of SOEs (SEST). The reasons behind that decision were different from those which would later lead to the sale of those companies, and this explains the emphasis on the creation of control agencies, and the very small importance given to the agencies responsible for selling state assets. The point in question at that time was not the inefficiency of SOEs, but the need to decelerate expansion of the state business sector, so as to control aggregate demand, a difficult task given the almost complete lack of control of these companies by federal authorities. The predominant view was well reflected by Rezende (1980), who, after rejecting “the hypothesis that private sector production is intrinsically more efficient than public sector production” (p.35), observed that (p.37):

“In fact, the whole debate on the need to limit the increase in the functions of the state reflects the incapacity of the public

administration to control the actions of government companies, whose decisions to expand escape the control exercised during the periodic analysis of the budget ... to the extent that the decisions to invest in certain sectors by private enterprises are subordinated to public credit and/or fiscal incentive schemes, control of the decisions of the privately-controlled companies is greater than the control of the decisions of the public companies, whose capacity to mobilize funds gives them a certain independence in relation to the central power.”

Thus, it was not an ideological about-turn on the developmental role of the state, but rather a change in the emphasis of economic policy, imposed by changes which were up to a certain point outside government control. The priority was no longer growth and import substitution, but control of inflation and, principally, overcoming the foreign exchange crisis. Since the SOEs were responsible for a considerable portion of domestic investment and consumption, it would be almost impossible to stabilize the economy without some form of control over their expenditures and without eliminating or at least reducing their deficits (Werneck, 1987).

The macroeconomic imperatives – in particular, the foreign exchange crisis – were to have two additional effects on the SOEs. Before the foreign debt crisis (1982), the SOEs were led to contract foreign loans beyond their needs, as a means of financing the country’s growing current account deficit. With their external obligations considerably increased, these companies were seriously harmed by the increase in international interest rates, starting in 1979, and the significant currency devaluation after 1983. Further, since 1975 the prices of goods and services produced by the SOEs had been reduced in real terms, initially to control inflation and, after 1982, to subsidize manufacture exports. Thus, the use of these companies as instruments of macroeconomic policy – with limits on their investments, increases in their debt, reductions in the real prices of their output, and indeed a loss of focus on their business objectives – would lead to a gradual but continuous deterioration in their performance, with the expansion of pent-up demand and loss of quality in their services.

It was not until 1981, however, that privatization would actually be put on the economic policy agenda. In July of that year, a presidential decree created the Special Privatization Committee (*Comissão Especial de*

Desestatização) and set “rules for the transfer, transformation and divestiture of companies controlled by the federal government”. The main objectives of the Special Privatization Committee were to strengthen the private sector, limit the creation of new SOEs, and close or transfer to the private sector the SOEs whose control by the public sector was no longer necessary or justifiable.

Once set up, this Committee identified 140 SOEs which were ready to be privatized in the short term. Of these, 50 were initially put on the list for sale. However, the actual balance of this first attempt at privatization was not to reach even this number: a total of 20 companies were sold to private investors, one was leased, and eight were incorporated into other public institutions. In this same period, however, six companies in a bankrupt situation were incorporated by the BNDES, through what were then called “hospital operations”. The companies sold in this period were, in general, cases of re-privatization, and their list did not include any of the major SOEs. The 20 companies privatized in 1981-84 totaled assets of only US\$ 274 million, employed a total of less than 5,000 workers, and their sale produced total proceeds of only US\$ 190 million. The highest revenue, US\$ 77.5 million, came from the sale of a group of companies linked to Riocell (wood pulp), and the lowest revenue, from the sale of Fiação e Tecelagem Lutfala, was only US\$ 2,000.

The speed of privatization in the Sarney administration (March 1985 to March 1990) was similar to that of its predecessor, in spite of the more aggressive rhetoric, as reflected in the series of presidential decrees and draft bills restructuring and enlarging the privatization program. In all, 18 companies valued at US\$ 533 million were sold, with a similar number transferred to the state governments, two merged into other federal institutions, and four closed down. Most of them were small- and medium-size companies in sectors where the private sector was dominant, and whose privatization was decided as a means to improve the financial health of their owner, BNDESPAR, the subsidiary of BNDES responsible for capital market operations. Their combined assets mounted to US\$ 2.5 billion, and together they employed 27,600 people.

On assessing the Brazilian privatization experience in the eighties, the World Bank (1989) concluded that “Brazil’s first flirtation with privatization was

a ‘classic example of failure’”. Indeed, both in terms of speed and scope, the sale of SOEs in the 1980s fell far short of the level promised by government rhetoric. Further, most of the sales were made by the BNDES, whose motivation for privatizing was more related to its need to free itself of problematic, loss-making companies than to a favorable perception about privatization on the part of the government¹¹. Privatization was not a priority for the public sector.

It could thus be argued that the privatization achieved in the 80s was that possible under the circumstances, three of which were particularly relevant in limiting the breath and depth of Brazilian privatization in its first decade:

[1] Until the middle of the decade, SOEs continued to show a relatively good operational performance, reducing the scope for productivity gains in the event of their transfer to the private sector. This, for one, constrained public support for privatization, and, for another, reduced the interest of private investors in buying those companies.

[2] The “protective mantle of ‘national security’” continued to be laid over the SOEs for most of the decade, in such a way that it would have been virtually impossible to sell large SOEs while the military maintained their influence in the federal government.

[3] As was well characterized by the 1988 Constitution, a large segment of Brazilian society, from the military to leftist parties, continued, like Severo Gomes 10 years earlier, to see privatization as a codeword for the denationalization of the economy, with multinational companies seen as the only ones able to buy the major Brazilian SOEs. And an enlargement of the presence of foreign investors in the economy was perceived to be against the national interest.

¹¹ Márcio Fortes (1994), president of the BNDES at the end of the Sarney government, and a central figure in moving privatization forward at a time in which the process faced little to no support, put the issue in the following way:

“Privatization, in reality, was not such a central policy. It was the need which the BNDES had, primarily, to generate funds from within its own equity holdings, secondly, to obtain liquidity for its normal activities, and, thirdly, because its own internal management was greatly weakened by the build-up of necessary

3. Brazilian-style privatization: pragmatism or ideology?

The previous section showed that perception on the role of the state in the Brazilian economy began to change during the mid- to late 1970s, and that it was not coincidence that by then Brazil's growth engine started to rattle, bringing to an end the long cycle of growth begun in the 1940s. The continuous deterioration of the economy – and in particular the fiscal crisis that emerged in the early 1980s – helped to provide support for Brazilian privatization in the subsequent years. Even so, years of rhetoric and privatization efforts produced only very modest results, which had only a marginal effect on the state's presence in the economy. Only very small companies, in sectors in which the state should never have entered, were privatized. More importantly perhaps is that there was no firm political commitment to privatization. In 1989, Congress rejected Provisional Measure 26, which would make all SOEs subject to privatization, except for those that could not be sold due to constitutional restrictions. Indeed, the 1988 Constitution was clearly a nationalizing one, establishing public monopolies in telecommunications, oil and distribution of gas, and setting up barriers to foreign ownership in mining and electricity.

Yet, less than two years after the promulgation of the new constitution, the Collor administration launched the Brazilian Privatization Program (PND), significantly widening the scope of privatization. What were the causes of this major shift in the official view of the role of the state in the Brazilian economy? The answers to this question include changes in the domestic and international political scenarios, the reorientation of the economic development strategy, a worsening of SOE performance, and the needs of macroeconomic policy.

A notable aspect of the discussion on privatization is how the issue of national security and, on a smaller scale and with a slight lag, the argument that privatization would lead to the denationalization of the economy lost

management activities in its day-to-day routine. It was, after all, owner or controlling stockholder of more than 25 highly complex companies.”

importance in the public debate. Instead, opponents of privatization criticize the minimum sale prices set for the SOEs, argue that the risks of transferring companies with market power to the private sector are too high, and doubt the benefits of privatization, particularly with regards to its impact on the quality of services offered. But little is said about the risk of denationalization of the Brazilian economy and even less about threats to national security, in spite of the high participation of foreign capital in the process since 1995.

To a large extent this change may be credited to the process of democratization, with the gradual move from military to civilian rule; together with an international environment characterized by the end of the Cold War. The importance of pressures from the military in the creation of SOEs goes back to the Vargas period, and it was not by chance that in other Latin American countries privatization also made significant progress with democratization. The fact that President Collor was elected by popular vote, in contrast to the negotiated transition that made possible the rise of Sarney to the presidency, was also important in legitimizing this change of direction. The end of the East-West conflict also helped to reduce pressures to keep strategic sectors, such as telecoms, oil and electricity, under state and national control. The same process was seen in the OECD countries, especially in Western Europe (Nestor and Mahboodi, 1999). In this respect it is probable that the 1988 Constitution would have had a less nationalizing and anti-foreign-capital bias, had it been written after the fall of the Berlin Wall and in an environment of weaker military influence.

The main feature of the change in development models in the early nineties was the shift from a strategy focused exclusively on the process of accumulation – presented as a concern to “occupy empty spaces” – to one more concerned with efficiency and productivity growth. Consequently, the very existence of a state company as an instrument of economic policy no longer made sense, for, if it serves to accumulate capital, it does so at the cost of a high burden on efficiency. Thus, it was not a mere coincidence that the PND (Brazilian Privatization Program) was launched simultaneously to trade liberalization and significant deregulation of the domestic economy, together with the ending of public monopolies on sectors such as sugar, ethanol, coffee, wheat, etc.

Moreover, at the beginning of the 1990s it became clear that the state had exhausted its capacity to lead the process of accumulation, since it was not capable of either generating a fiscal surplus nor of borrowing abroad. Finance to SOEs disappeared for another less obvious reason: because virtually all long term credit in Brazil was (and still is) extended by public banks. Because these could not execute the collateral given by SOEs, for political and legal motives, SOEs did not bother to pay back.¹² So in the mid-eighties public banks were forbidden to lend to SOEs, drying up their last source of finance. Privatization became then the only means through which public banks could finance the sectors in which SOE presence was massive – being private, these companies could credibly offer their assets as collateral. This was the common ground that allowed a tactical coalition between those who believed that the state should permanently exit commercial activities and those that saw privatization as a necessary evil.

The deterioration in the performance of the SOEs in the eighties also contributed to rise the support to privatization. In the second half of the 80s, a large number of management positions was filled up by political appointees with scarce management skills, who usually remained in their posts for only a short period. They were rarely *de facto* subordinated to their line minister, and even more rarely were they compensated on the basis of the economic-financial performance of the companies they managed. In addition, with the relaxation of fiscal constraints, *vis a vis* the early eighties, SOEs were back on operating with soft budgets, with the federal government coming to their rescue when necessary. Investment was the only type of spending kept under control. As a result, SOEs developed new vices, without recovering their old virtues, vices which were made all the more evident by the process of trade liberalization, which revealed inefficiencies previously hidden by SOE monopoly positions.¹³

¹² In fact, SOEs failed to pay not only the public banks, but also its SOE suppliers: the steel company would not pay its electricity supplier, which would not pay the power generator, which would not pay the oil company that supplied its fuel and so on. And there was little creditors could do beyond exerting political pressure, not the least because legally a creditor cannot ask for a SOE bankruptcy. As arrears built up, these multiple defaults were “solved” transferring debts to the Treasury, with the taxpayers picking the tab.

¹³ The opening to imports also helped to increase the support of business for privatization. While the economy was closed, all companies were equally harmed, for example, by the low supply and bad quality of telecommunication services. Thus, this was not an important differential in their capacity to

Nonetheless, the main driving force in overcoming inertia and widening the scope of privatization was the poor performance of the economy in the late eighties (Pineiro and Giambiagi, 2000). For one, because this limited the government's degrees of freedom in conducting interventionist policies, forcing it to adopt more market-oriented development strategies; for another, because it increased the need to control the spending of the SOEs, at a time when these companies needed massive investment to modernize and expand output capacity.

In particular, the original logic of the Brazilian Privatization Program (PND) was directly linked to the stabilization program launched at the beginning of the Collor government, what explains the new government's decision to privatize rapidly and independently of the unstable macroeconomic situation of the time. On the one hand, fiscal revenue was increased with the creation of Privatization Certificates, a security compulsory acquired by financial intermediaries and that could be used only to buy SOE shares. On the other hand, and even more important, the government expected to drastically reduce the public debt by accepting public debt securities as privatization currencies, in this fashion cutting the fiscal deficit and consolidating price stability. Foremost among these privatization currencies were the tens of billions of dollars in private savings, denominated in new cruzados, the old currency, which were temporarily frozen at the Central Bank as part of the stabilization program launched simultaneously with the PND. These frozen savings, due to be returned in 12 installments, starting in November 1991, were expected, in turn, to guarantee a high demand for SOE shares.¹⁴

The synergy between stabilization and privatization was to fail due to problems in both programs. Privatization began with very optimistic targets in terms of revenue and timetable, which turned out to be impossible to fulfill due to the bad financial situation of the SOEs and the complexity of these companies' stockholders' agreements¹⁵. The SOEs were not ready for sale:

compete. With trade liberalization, the bad quality of public services became a barrier to competitiveness for the private sector, giving rise to the expression "Brazil cost".

¹⁴ This question is discussed in greater detail by Pineiro and Giambiagi (2000).

¹⁵ When the PND was launched, in the first half of 1990, the government promised very significant results in the short term. In early May 1990, the government forecasted revenues of US\$ 9 billion for

they needed a long process of preparation before they could be privatized. As is known, it was only at the end of 1991 that the first company was sold under the PND. Since at that time the new cruzados were beginning to return to private investors, regaining their liquidity, their use as a privatization currency turned out to be almost nil. Thus, even though privatization revenues continued to be used to reduce the public debt, the original logic of the PND had to be changed, to the extent that the new privatization currencies were liabilities with relatively low liquidity. That is to say, the impact of privatization on the profile of the public debt was to be much less positive than initially projected.

As the failure of the Collor government's first stabilization plan became increasingly evident, the government started to rely on the PND as a proof of its commitment to structural change. This caused the program to continue, even after Collor's impeachment and the rise to office of a president who had previously publicly voiced his opposition to privatization. However, rising inflation and low growth reduced the already compressed levels of domestic and foreign investment, severely limiting the scope of privatization. Thus, until 1996 the role of privatization in Brazil's macroeconomic policy was essentially that of signaling commitment to reducing the size of the state and implementing structural reforms. In fact, even the policy of using privatization revenues exclusively to retire public debt was strongly questioned by sectors of the government itself, and was indeed partially abandoned in some cases.

In all, 33 companies were privatized during the Collor and Franco governments (1990-94), for total revenues of US\$ 8.6 billion, and transfer to the private sector of US\$ 3.3 billion in debt (Table 1). Almost all companies were in manufacturing, with revenues concentrated in the steel, petrochemical and fertilizer sectors. The companies selected for sale had in common belonging to relatively competitive sectors or to ones for which trade liberalization would create a competitive environment. Included in this profile were: (i) the small companies absorbed by the state; (ii) the subsidiaries established after the 1967 reform, with the verticalization and diversification of

the whole of the year. This forecast fell to US\$ 7 billion at the end of that month, and to US\$ 4 billion at the end of July. Around mid-year, the target for proceeds of the program in its first two and a half

the major SOEs; and (iii) the state steel companies, for which there was a reasonable consensus that the presence of the state was no longer necessary. The privatization of the state monopolies was not even considered at the time.

Starting in 1995, the scope of privatization was greatly widened by two almost simultaneous movements: the determination to end the public sector monopolies in infrastructure, and the decision of the local state governments to develop their own privatization programs (Table 1). In all, the 80 privatizations in the period 1995-98 provided total revenues of US\$ 60.1 billion, and transfer of debt to the private sector amounting to US\$ 13.3 billion.

Several factors contributed to these two movements. First, the repeated failures of successive governments to control inflation had limited their ability to follow a more aggressive privatization program. The success of the Real Plan in achieving stabilization gave the government the political leverage required to get the necessary constitutional amendments through Congress, so as to extend privatization to the telecom and gas sectors and to facilitate its progress in mining and electricity. Second, to sustain price stability the government needed to achieve fiscal discipline, and this limited its ability to carry out the high levels of investment necessary to increase supply at the pace required by the recovery in economic growth. Also for fiscal reasons, economic policy limited the access of SOEs to domestic and external financing.

Third, the states saw in privatization an important source of funding, which would allow them to reduce their debt (both registered and non-registered) and, in some cases, expand spending. Moreover, in the debt restructuring contracts between the states and the federal government the latter included clauses that required the states to amortize part of the principal, what could be done only through the sale of their assets, i.e., through privatization [Pinheiro and Giambiagi (2000)]. An additional stimulus was provided by the contracts of the states with the BNDES, which made it possible to borrow against future privatization revenue. Fourth, stability itself, and the change in the perception of risk and growth potential of the Brazilian

years was US\$ 17 billion, with the sale of one state company per month in the second half of 1990 [Schneider (1990a, p.17-18)].

market – reflected, for example, in the high growth in foreign direct investment flows – helped to increase the value of these companies, making privatization more interesting both for the public sector and for private investors.¹⁶

Fifth, the success of the privatizations carried out in 1991-94, evidenced by the companies' increased efficiency and investment, helped to widen political support for the program. Pinheiro (1996) shows that privatization substantially improved the performance of the former SOEs, with significant increases in real sales, sales per employee, net profit, stockholders' equity, investment, fixed assets and the ratio of investment to sales. Efficiency practically doubled when measured in terms of sales per employee, increasing 83% when gauged by labor productivity. Profitability went from negative to positive, stockholders' equity increased by a factor of almost five, while debt diminished and liquidity increased. The median investment also increased almost by a factor of five, rising more than four times as a proportion of sales and more than doubling in relation to fixed assets. Sales per employee went up in 92% of the companies, net profit in 78% of them, investment in 93% and labor productivity in all of them.

Of all the factors contributing to expand privatization in Cardoso's first term, the most important was the role played by privatization in sustaining his stabilization program, the "Real Plan". With the large sales of 1997-98, Brazil attracted sizable volumes of foreign direct investment, which helped to finance the country's high current account deficit – in 1997-2000, the ratio between FDI inflows associated with privatization and the current account deficit averaged almost 25%. Privatization was also instrumental in averting an explosion in public debt, in spite of the growing fiscal deficit posted since 1995. Carvalho (2001) shows that thanks to the predominant use of privatization to abate public debt, in December 1999 this was 8.4% of GDP lower than what it would have been without privatization.

¹⁶ Economic instability was also the main reason (though not the only reason) for the lack of interest of foreign investors in Brazilian privatization until 1994 – in this period foreigners participated with less than 1% of total revenues. Currently this share mounts to 46%.

Table 1: Privatization Results: Proceeds and Debt Transferred, 1991-2000 (US\$ million, up to November 2000)

	Annual Proceeds										General Total		
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Proceeds	Debt Transferred	Total
Total	1.61	2.401	2.627	1.966	1.004	5.486	22.616	30.975	3.202	10.201	82.092	18.076	100.168
1. Federal	1.61	2.401	2.627	1.966	1.004	4.080	8.999	23.478	554	7.635	54.358	11.326	65.684
Steel	1.47	921	2.250	917							5.562	2.626	8.188
Petrochem		1.266	172	445	604	212					2.699	1.003	3.702
Fertilizers		202	205	11							418	75	493
Mining				6			3.299				3.305	3.559	6.864
Railroads						1.477	15	205			1.697		1.697
Ports							251	149	21		421		421
Electricity					400	2.358	270	880	1		3.909	1.670	5.579
Oil and Gas										4.032			
Financial							240			3.595	240		240
Telecom							4734	21823	421	0	26.978	2.125	29.103
Minority				395		33	190	421	62	8	1.101		1.101
Other*	140	12		192					49		393	268	661
2. States						1.406	13617	7497	2648	2.566	27.734	6.750	34.484
Telecomns								1018			1.018	822	1.840
Financial							401	647	147	869	1.195		1.195
Gas							576		1131	298	1.707	88	1.795
Electricity						587	9945	5166	1370	1.293	18.361	5.840	24.201
Water&Sew										106			
Railroads						25		240			265	-	265
Other**							307	96			403		403
Minority						794	2388	330			3.512		3.512
No of SOEs	4	14	6	9	8	18	36	18	11	6			130
Federal	4	14	6	9	8	16	21	7	6	1			92
States						2	15	11	5	5			38

Source: BNDES.

To the extent that Brazilian privatization (as had been the case in the past with the process of nationalization) was the result more of pragmatism than of an ideological change, two important questions deserve to be considered. First, since a large part of the SOEs has already been sold, and given that revenues are expected to fall in the coming years, shall we expect privatization to end in the near future? Second, to what extent is there a risk that the pendulum might swing back, this time in the direction of greater state intervention in the economy, and possibly a renewed movement of nationalization in infrastructure sectors? The two next sections deal with these questions.

4. The frontiers of privatization

Our look at the history of privatization in the earlier sections of this paper showed how its frontiers expanded over time, from a simple helping hand to private firms, to control of SOE growth, and finally to the sale of large and traditional state companies. In particular, we stressed the importance of the virtuous circle between privatization and stabilization, in which the latter created the political conditions for expanding the process, while privatization was instrumental in sustaining stability. This was the case, in particular, in 1996-98, when the dynamics of privatization was closely linked to the needs of the price stabilization program.

It is perhaps not surprising, therefore, that the priority ascribed to privatization would decline in 1999-2000, when fiscal adjustment and an exchange rate devaluation put the Real Plan on sounder footing. The primary fiscal balance turned from a deficit of 0.9% of GDP in 1997 into a surplus of 3.2% of GDP in 1999 (3.5% of GDP in 2000). Meanwhile, the current account deficit came down, while inflows of non-privatization-related FDI went up, reducing the importance of privatization for the finance of the external deficit. Moreover, with the stagnation of growth, the rise in unemployment and the decline in real incomes in 1998-99, the government's popularity fell substantially, reducing its political degrees of freedom. So, after the record results of 1997-98, proceeds dropped substantially, with a considerable

slowdown in the privatization of electricity generation and water and sanitation (Table 1).

This slowdown also resulted from a change in the focus of privatization. Fiscal discipline and a floating exchange rate lightened the burden carried by monetary policy since 1994, allowing for a reduction in interest rates. With this, the opportunity cost of using privatization for other ends that not maximizing the amount of public debt redeemed with the sale of SOEs also declined, encouraging a shift in priorities. In this case, towards using privatization to strengthen the stock market, through the use of large flotations as a means to sell SOE shares. This alternative, although foreseen when the PND was established, had been used before only in a few cases and on a small scale. In contrast, in the sale of Petrobrás shares, in August 2000, 337 thousand individuals bought shares, possibly a record in the history of Brazilian stock market.

This change in focus might give the government new enthusiasm to move with privatization, to which may also contribute a rise in popularity, as economic conditions improve. Although privatization is not expected to repeat the record results of 1997-98, quite sizable assets, consisting mainly of electricity generation and distribution companies and minority stockholdings in companies already privatized, have already been lined up for sale. Once these are sold, the federal government will still own large assets in the transportation (e.g. airports), bank and oil sectors, while sub-national units will be left with almost complete ownership of the water and sewage sector. Will these assets be transferred to the private sector in the foreseeable future?

In the medium to long term, the future of privatization will depend on both political and economic factors. On the political front, it is not yet clear what view about the role of the state in stimulating economic development will prevail in the future. As remarked earlier, the approval of the reforms in the nineties reflected, above all, a tactical alliance, resulting from the excesses of the previous model and the lack of fiscal instruments to back a more intrusive industrial policy. In this sense, the urgency of the macroeconomic crisis served to bring together currents of opinion with very different views on this issue. So, the emphasis given in this paper to the economic motivations of privatization does not mean that we expect its future to depend exclusively or

mostly on economic arguments. As Feigenbaum, Henig and Hamnett (1999, 172) alert:

“[A]n exclusive focus on economic forces obscures the intensely political nature of the privatization movement. Privatization initiatives are political because they redistribute costs and benefits among diverse and competing groups. And portraying privatization as a necessary adaptation to fiscal constraints fails to acknowledge the considerable range of alternative responses open to governmental actors and the extent to which selection of policies within that range may reflect partisan tactics and pressure from mobilized interest groups.”

There is still much that can be done in Brazil to deepen trade liberalization, deregulation and privatization. But with fiscal policy back in order, the government may also opt for a more interventionist strategy – e.g., through “occupation of empty spaces” by national champions – and in this case it will be unlikely to let go policy instruments such as the remaining SOEs. A central issue in this context will have to do with how the channeling of long term savings to investment takes place; that is, who generates these savings, if the state or the private sector, and who is responsible for the corresponding financial intermediation. During the high growth period that followed the end of WW II and lasted until the late seventies, the state was responsible for both activities, which as we saw favored the expansion of the SOE sector. With the deterioration of the fiscal accounts during most of the eighties and nineties, the state was a net dis-saver, but nonetheless kept a quasi-monopoly in the intermediation of long term finance, through its public banks. And this gave it great leverage in influencing investment decisions by private firms, one that was less or more used depending on momentary political conditions. As we discuss in the next section, this institutional set up in credit markets, coupled with a small equity market, in which public banks and SOE pension funds also play an important role, provides for a means through which the process of state retrenchment may be reversed in the future.

This political debate will greatly depend, however, on privatization’s own success in increasing supply and efficiency, and in transferring productivity gains to consumers, in the form of lower prices and better quality. This will be particularly important in public services: electricity, telecom, water services and transportation network. Therefore, the future of privatization will

depend directly on the effectiveness of infrastructure regulation. It will be the success of structuring the state as a regulator that will determine the fate of the state in business.

All of Brazil's infrastructure sectors have now been subjected to some form of privatization, with substantial cross-sector variation in the quality of regulation. The sale of assets has now been completed in the telecom and railroad sectors. In the electricity industry, 63% of distribution is now in private hands. Also, the vast majority of cargo that enters and leaves the country is now handled in private port terminals. On the other hand, private sector activity is only beginning in highways and water services, even if some important privatizations have already taken place.

The importance of good regulation for the success of privatization has been recognized in all the sectors. With varying degrees of success, an effort has been made to decide the regulations before privatization and, when this did not happen, concession contracts contained several regulatory clauses. There has also been, in general, a concern to introduce competition in the sectors being privatized, through the setting up of a non-monopolistic industry structure, at least on a nationwide scale, with several SOEs being separated both horizontally and vertically before privatization. Examples of horizontal separation include the railroad, electricity and telecom sectors, and examples of vertical break-ups were telecom and electricity. In addition, limits were imposed on the participation of individual investors in different markets, regional and national, and even on the ownership structure of some companies (such as CVRD and the railroads). Also, by law, each privatization sale is subject to approval by the competition agency.

Another important feature is that the changes in regulation and the setting up of regulatory agencies have taken place almost exclusively at the federal level – in spite of the fact that the operations of the privatized companies have important implications at local level, and that some one third of the proceeds from privatization (US\$ 27.7 billion in revenues from the sale of 38 companies) has been obtained from privatization programs of the individual states. Regulation, both in technical and in economic terms, has in general been carried out by sector, instead of separating the two types of regulation and having a single agency taking care of the economic regulation

and competition for the various sectors. However, the few states which have set up regulatory agencies so far have opted for multi-sector regulators.

The most successful case of privatization cum regulatory reform is, undoubtedly, telecommunications.¹⁷ The process began with the approval of the so-called “ Minimum Law”, which enabled the B-Band cellular telephony concessions to be auctioned.¹⁸ This was followed by a significant tariff rebalancing in 1996 and 1997, then approval of the General Telecommunications Law in 1997, creation of the Brazilian Telecommunications Agency (Anatel), the sector regulator, in the same year, and culminated in the privatization of Telebrás, the public monopoly company, in 1998. Thus, when privatization took place, the entire regulatory structure was already established and the regulatory agency responsible for the sector was functioning at full steam. Indeed, telecom companies signed concession contracts in which the new regulatory environment was embedded while they were still state owned, so that the new owners knew exactly what rules would be in force after privatization.

This is also the sector with the most ambitious targets for investment and for competition. The concession contracts require expansion of the number of fixed lines from 15.3 million to 50 million, and the number of cellular lines from 4.0 million to 26.2 million in the period of 10 years, a growth of 226% and 550%, respectively. Two years after privatization, the number of fixed lines had reached 35.0 million and that of cellular phones 21.5 million, almost doubling the number of lines. Competition has been gradually increased:

- Telebrás was divided into 13 companies, of which one was the long-distance carrier, three were fixed-line and nine mobile-phone companies. These nine companies corresponded essentially to the areas previously auctioned for the B-Band, so that when privatization occurred there was a “duopoly” in cellular telephony in each concession area.
- Restrictions were also placed on a single investor having stockholdings in more than one area or more than one service.

¹⁷ Detailed descriptions of privatization and of the regulations for the telecom, electricity, transport and water services sectors can be found in Pinheiro & Fukasaku (2000). For more information on telecom, see also Pires (1999).

¹⁸ The B-band companies are private sector firms operating in a range of the spectrum different from the one used by former SOE operators, this being called A-band.

- In 1999, Anatel auctioned concessions for fixed-line operation in each area, so that currently these are also duopolies. The same happened in the long-distance segment.
- The fixed-line companies were allowed to compete with the long distance companies within their own concession areas beginning in 1999.
- Entry in the market will be totally deregulated starting in 2002, but existing operators will be free to enter other markets only if they fulfill all Anatel's supply and quality targets before that date.

The coordination between regulation and privatization in the electricity sector was much less well executed than in telecommunications. For example, Aneel, the sector regulator, was created only in 1997, two years after privatization in the sector had begun. The Energy Wholesale Market (*Mercado Atacadista de Energia – MAE*) and the National System Operator (*Operador Nacional do Sistema - ONS*), two central elements in the new regulatory model, were created only on September 30, 1998, when a large portion of distribution was already in private hands.

Indeed, due to the lack of progress in defining the regulatory rules for the sector – which, we note in passing, began to be debated as early as 1992 – just going ahead with the sale of SOEs turned out to be a way to force decisions on regulation. This perverse order of events also tended to limit the capacity of the regulatory agency to operate, and as a result, limited its prestige in the eyes of the public at large. Moreover, electricity regulation continues to lack a clear separation between the functions of the various agencies involved (Aneel, ONS, the Mining and Energy Ministry and Eletrobrás, the public sector electricity holding company), reducing the accountability of the various institutions.

Even so, electricity reform has also been characterized by a concern with the introduction of competition and the gradual de-regulation of contracting among different players. The first element of this strategy was the concern with both vertical (generation, transmission and distribution) and horizontal separation of SOEs, at the federal and state levels. Second, limits were set on market concentration, at national and regional levels, for

distribution, generation, and the sum of the two¹⁹. Third, a timeframe was established allowing an increasing number of consumers to freely choose from which company to buy electricity, with a gradual reduction in the minimum level of demand necessary for a consumer to have such freedom. Also, an increasing flexibility was given to generators and distributors to contract between them, with complete de-regulation to be in place nine years after privatization.

In transportation, the quality of regulation varies among the different segments. Privatization of highways was closely based on the franchise bidding, or concession auction, model proposed by Demsetz (1968) and others as an alternative to economic regulation. In federal privatization auctions, a minimum set of investments was defined, including rehabilitation and expansion of the existing network, and the concession was given to the bidder that offered to charge the lowest toll rate. Once this was decided, regulation was limited to inspection of investment and operation activities and the annual tariff adjustments – that is, regulation has been mostly technical. The states, which as a group privatized nine times as much as the federal government, followed a similar model, but some of them charged a fixed positive price for the right to explore the concession.

In the privatization of ports, the emphasis has fallen on container terminals, since private terminals already handled the great majority of bulk and liquid cargo. Container terminals in all Brazil's major ports were privatized. The evidence so far is that these privatizations made possible a considerable increase in investment and productivity, but that a minor part of this rise in productivity was transferred to consumers by way of lower prices. The explanation for this appears to be the absence of significant competition, which in turn resulted from two factors: high concentration of traffic in the port of Santos (above 40%), and the low efficiency of the railroads.

The privatization of railroads included the RFFSA (former federal railroad network), Fepasa, Ferroeste and the railroads from CVRD (the latter were sold with the rest of the company). Before RFFSA was sold, it was split

¹⁹ 35% of the market in the North, Northeast and Center-West, 25% in the South and Southeast, and 20% in the national market as a whole. For generation and distribution together, the limit is 30% of the national market.

horizontally into six networks. This was the privatization in which the greatest responsibility was given to competition, in this case inter-modal competition, as an instrument of self-regulation. The result has in general been positive, due to the predominance of highway freight haulage in Brazil, with large increases in productivity, admittedly from a very low base, but there have been some cases of abuses of captive consumers and price discrimination (see for instance Estache, Goldstein and Pittman, 2000). In this way, although a 20% cap was set for the shareholdings of each investor in each network, railway concessions were mostly awarded to consortia formed by large customers, who were in a position to harm their competitors by discriminating against them in the supply of railroad services. Further, several companies have not met the contractual targets for production and reduction in the number of accidents without sanctions having been imposed.

The sector in which least progress has been made, both in regulation and in privatization, is water and sewerage services. Although there have been privatizations in several municipalities, some initiatives were aborted and none of the large state companies has yet been sold. There is an enormous regulatory *imbroglio* in this sector, with both states and municipalities claiming the right to award (i.e., sell) concessions. It is likely, however, that some agreement may be reached, since the investment needs and the possible gains in efficiency in this sector are gigantic.

So, in sum, the regulation of public services has in general progressed less than privatization in recent years, with much still to be defined in the transport and water/sewerage sectors. Moreover, although there has been a concern in all the sectors to introduce competition, only in telecom was this made a major priority; stronger action is needed in electricity, ports and railroads. There are three additional issues that raise concerns regarding the regulation of public utilities in Brazil. One, the risk of an exaggerated emphasis on technical regulation, which could result, for example, from the staffing of regulatory agencies essentially with former SOE employees. In these companies an excessive emphasis was given to technical aspects and little concern to client satisfaction and other commercial aspects of the business. The experience in other Latin American countries also shows an exaggerated interest of regulatory agencies in technical issues, to the

detriment of economic regulation. Two, the risk that regulatory agencies are side-tracked into pursuing policies other than the ones for which they were conceived. In particular, greater emphasis should be given to competition in the mandate of these agencies, while, on the other hand, it should be clear that this mandate does not include the implementation of industrial policies in the sector being regulated, or in upstream or downstream sectors.

Three, it is still not clear how the Courts will behave in the event of disagreement between regulators, concession holders and consumers. The Brazilian Constitution, like that of other countries, gives the parties the right to go to Court against decisions of the regulators. But, as in most of the rest of the world, the Brazilian judicial system is ill equipped to deal with the economic and technical aspects that usually arise in these disputes. Further, many of these disputes require rapid decisions, at the risk of causing large losses to the parties involved. The option of recourse to the Courts should not be allowed to constitute only, or mainly, an opportunity to delay implementation of decisions already taken by regulators. Therefore, even though the judiciary has an important role to play in this area, it should strive to limit its interventions to guaranteeing that procedural rules are respected.

5. Final observations

In 1991-2000, Brazil privatized 130 SOEs, generating revenues of US\$ 82.1 billion and transferring debts of US\$ 18.1 billion to the private sector. These figures make the Brazilian privatization one of the largest in the world – for example, up to 1997 the total of privatization in all the OECD countries mounted to US\$ 153.5 billion [Nestor and Mahboodi (1999)]. But it is not only the scale of the companies involved that makes the program noteworthy. Equally important is the fact that in only four years the state has greatly reduced its participation in sectors in which for several decades it was the single producer. Ironically, the participation of SOEs in the Brazilian economy in 2000 was not much different from that a century before. Thus private investors now control the telecom and railway sectors, the country's largest

ports, some of the main highways, two-thirds of the distribution and a fifth of the generation of electricity, together with a small but growing share of sewage and water services. Some large public banks have been privatized, while the oil and gas sectors were open to private investment. Only 10 years ago, few would have foreseen such remarkable transformation.

In this paper we argued that privatization in Brazil resulted essentially from three factors: changes in politics, with foreign ownership of infrastructure and basic input sectors no longer seen as a threat to “national security”; a shift in the focus of development policies towards efficiency and away from the mere accumulation of capital; and a close relationship between privatization and macroeconomic policy. We also argued that the macroeconomic policy connection was the most important factor of the three. In this respect, the paper showed that it was not by chance that the first attacks on SOE expansion occurred in the mid-seventies, when the growth cycle started in the forties showed the first signs of exhaustion. Since then, and until not so long ago, Brazil’s failure to stabilize its economy and resume sustained growth served as the main motive for privatization to reach sectors which some years before were not seen as privatizable.

How far will this process go? Already on the privatization pipeline are the remaining SOEs in the electricity sector, some state banks, the reinsurance monopoly and a large part of the sewage and water sector. When this phase is concluded, the state will still own some large assets in the oil and gas, transportation, and banking sectors. Moreover, privatization still has a long way to go in the outsourcing of activities within the public sector: mail services, garbage collection, vehicle inspection, etc. But the actual extent and speed of the expansion in the frontiers of privatization will depend on the role ascribed to the state in the policy framework of future governments and, no less importantly, the success of past privatization in enlarging supply, reducing prices and improving service quality. Brazil has already taken important steps in establishing a regulatory environment targeted at achieving these results, but there is still much to be done.

Is there, on the other hand, any concrete possibility that the pendulum will swing the other way, that is, in the direction of a greater presence of the

state in business? Yes. We envisage at least three possible (related) scenarios in which this could occur.

First, regulation fails to encourage the levels of investment necessary to increase supply consistently with demand, generating shortages and harming consumers. In this case the state may feel compelled to come with the necessary investment, progressively increasing its participation in supply, possibly to the point of again dominating the sector. Regulation may fail if regulatory agencies lack the necessary means to perform their duties, particularly well-trained personnel, or sufficient independence from political powers. Lack of accountability to the different parties involved may also be a problem. A relevant source of concern in this case is that regulation of infrastructure is aimed at developing domestic production in specific industrial sectors (“occupying empty spaces”) or used with electoral objectives, through fixing tariffs at artificially low levels.

Second, default on loans extended by public banks, particularly in infrastructure, put former SOEs back in the hands of the state. Obviously this same risk exists with other loans by public banks, but the problem is composed in this case by the difficulty of liquidating public services companies or of selling them to third parties. Typically, private investment projects in infrastructure have been financed through a combination of 30% equity, 40% credit from public banks and 30% in finance from multilateral institutions (IADB, World Bank, etc.), which also carries an implicit “guarantee” by the state, for it being the firms’ regulator. The exposure of public banks needs to be constrained, either through the securitization and sale of these credits or by attracting private banks to finance a substantial part of these projects. Yet, in both cases the necessary markets are missing. A larger participation of private financiers will be beneficial also to increase the productivity gains generated by privatization, due to the comparative advantage of private banks and equity investors in selecting and monitoring investment projects. Therefore, reforming capital markets – by way of establishing good rules and regulatory agencies – is key not only to decrease the risk of nationalization, but also to have privatization bear its full benefits.

Third, excessive protection to investors – e.g., against exchange rate devaluation – causes political costs to be higher than nationalization.

Recently, the state has been sued and condemned to financially compensate airlines, in billions of dollars, for the loss of profitability resulting from the government capping ticket prices below what the courts considered to be reasonable. This highlights the magnitude of contingent fiscal liabilities that may be created by legal or contractual clauses aimed at protecting investors from “excessive” risk. One should bear in mind the lessons from the experience of guarantees extended to railways and sugar plants in late XIX century, alluded to in section 2.

Therefore, to augment the stability and benefits of private ownership of former SOEs, particularly in infrastructure, Brazil should strength regulatory institutions and reform capital markets. Moreover, one should try to attract the most possible competition in all infrastructure sectors, lightening the burden of regulation, not only for the usual arguments of asymmetric information, but also to compensate for institutional weakness, a problem of much lesser magnitude in industrialized countries.

But while a scenario of re-nationalization is plausible, it is not likely, at least in the short- to medium term. For one, because public savings should stay low for several years, which makes a sustained policy of high public investment difficult to pursue. For another, because privatization, like other reforms put in place in this decade, creates parties interested in maintaining the new status quo. That is to say, the pendulum does not swing back automatically, like in a clock; it needs to be pushed, overcoming the opposing forces of inertia and established interests, something which history has shown to be a slow process. Rodrik (1998) illustrates this point with the experiences of Chile and Bolivia, and calls attention to the fact that the greatest guarantee that reforms will be sustained is their success in ensuring stability and economic growth. This is also the principal lesson of the Brazilian experience: development models last for as long as they are capable of producing economic growth, and are replaced when it becomes clear that they are no longer able of doing so.

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