Privatization and Deregulation in Mexico

Mexico's restructuring of telecommunications and road transport—two sectors vital to the country's business activities and external trade—resulted in the privatization of the public telephone company, Telmex, and deregulation of Mexico's trucking industry. The reforms, begun in 1989 as part of a larger program of structural reforms and supported by a $380 million World Bank loan, aimed at promoting private sector participation and increased reliance on market forces.

A recent OED audit* found that in both sectors the reforms achieved, and in many cases exceeded, their goals. In telecommunications, privatization reduced costs, expanded telephone coverage, increased labor productivity, and added to government revenue and investor profits. With deregulation, at least 30,000 new trucking firms entered the market, rapidly increasing competition. The result was greater operating efficiency and lower transport costs.

Background

In the 1980s, Mexico's telecommunications sector, particularly its state-owned telephone system, suffered from poor service and sluggish growth. And the country's trucking industry was heavily regulated with layers of restrictions that impeded its efficiency. As part of broader reform measures to reduce government regulation and increase reliance on competitive market forces, the Mexican government in 1989 introduced reforms to restructure both telecommunications and road transport. The World Bank supported these measures with a $380 million sector adjustment loan approved in 1990.

Project goals

In telecommunications the large state-controlled monopoly, Teléfonos de México (Telmex), was inefficient. Despite connection charges as high as $600 for residential and $1,100 for commercial users, would-be customers faced waiting periods of one to two years. The telephone excise tax of 60 percent was one of the highest in the world. Tariffs were highly distorted, with long-distance rates subsidizing local service for which charges were far below cost.

In road transport, major problems plagued the trucking industry. Trucking, which transported about two-thirds of the cargo in Mexico, was until 1989 highly regulated. Regulation was thought to promote evenness of service and prices and prevent cost-cutting practices that might increase accidents and pollution. But regulation served only to restrict competition, limiting the industry to only a few firms. As a result rates remained high and service poor.

In telecommunications, the reform measures aimed principally at privatizing Telmex (about 49 percent of whose shares were already owned by private domestic and foreign investors). At the same time, reforms sought to divest the operational functions of the Ministry of Communications and Transport (SCT) while strengthening the ministry's regulatory function. Toward the latter goal, the Bank approved an additional $22 million technical assistance loan.

In road transport, the principal objectives of the reforms were to deregulate the trucking industry, increase funding for highway maintenance, and initiate an emissions inspection program.

In both telecommunications and road transport, reform was initiated, designed, and championed by Mexican officials—a factor that counted heavily in the program's success. The Bank maintained close, continuing dialogue with Mexican officials and worked with them in formulating the reforms.

At the time the Bank loan was approved, reforms in the telecommunications sector were well underway. In road transport, the

*"Performance Audit Report: Mexico—Road Transport and Telecommunications Sector Adjustment Loan," Report No. 14400, April 1995. Performance audit reports are available to Bank executive directors and staff from the Internal Documents Unit and from Regional Information Service Centers.
Measures complementing deregulation

- Improving highway safety. Road accidents account for about 3 percent of all deaths in Mexico, a considerably higher rate than in countries with much greater motorization. Studies showed that 25 to 30 percent of trucks were overloaded. Although the government embraced deregulation of the trucking industry, it had no intention of stopping highway safety regulation. The government prepared a study that included recommendations for increased regulation of the sizes and weights of trucks. After the study was completed, the government in February 1994 issued new size and weight regulations to be phased in within three years.

- Increasing the price of diesel fuel. To force truckers to pay their full costs of road use, the government agreed to raise the price of diesel fuel at least 10 percent in real terms. In fact, the government raised diesel prices 17 percent in May of 1990 and another 10 percent in November of that year. With these changes, the real price of diesel fuel increased by 21 percent in real terms during 1990. Cost recovery has increased further in recent years. According to the Ministry of Finance, truckers in 1994 were paying nearly the full cost of road use.

- Increased financing for highway maintenance. In 1991 about 60 percent of the roads in the federal highway system were rated in poor or very poor condition. During the late 1980s the government spent only about 30 percent of what was needed to repair the roads, resulting in a large backlog of work. The government agreed to budget 475 billion pesos in 1991 to reduce that backlog. The government has in subsequent years continued its commitment to highway maintenance. Nonetheless, it will be many years before the backlog is eliminated.

- Adjusting rail tariffs. The government agreed to raise railway tariffs by at least 25 percent (in real terms) on most commodities transported by Mexico’s state-owned railway company. The purpose was to reduce the large subsidies received by the railway. The railway company raised rates twice during 1990: by 23 percent (in nominal terms) and then another 15 percent. The increases brought tariffs to 97 percent of costs. However, the policy of matching tariffs with costs was not sustained. In 1991, the percentage of revenues to costs fell to 87 percent.

- Installing a program of vehicle emission inspection. The government also agreed to put in place a system for periodic inspection of trucks for compliance with federal emission standards. In May 1990, the government issued regulations for mandatory inspections. As of May 1994, some 370 emission inspection stations were operating in Mexico. Of these, 147 were in the Mexico City metropolitan area, where air pollution is most severe.

Bank believed that certain additional measures were needed to improve the subsector as a whole. Five measures were identified, ranging from highway safety improvement to the establishment of a vehicle emission inspection program (see box). The Bank made the implementation of these measures conditions for the release of the second tranche of the loan. All measures were carried out on time.

Telecommunications

Privatization

Privatization of Telmex proceeded much faster than could have been predicted at the time. Before 1989, the only countries that had privatized their telecommunications sectors were Japan and Great Britain. And in those cases, the process had moved slowly. In the case of Mexico, the government introduced a comprehensive array of reforms and moved quickly to implement them. It scrapped the excise tax, partially rebalanced local and long-distance telephone rates, and began selling shares of the company. At the same time, it successfully renegotiated labor contracts, bringing the unions on board in support of the privatization effort. By May 1994, the government had divested itself of all but 2 percent of its holdings through global offerings. The controlling block, as initially required, was sold to a consortium of Mexican and foreign investors.

In the divestiture, Telmex was granted exclusive rights to domestic and international long-distance service for six years after privatization. All other activities, such as Yellow Pages, value-added services, cellular telephony, were opened to private participation. (Private networks had been liberalized earlier in the aftermath of the 1985 earthquake.) Telmex was permitted to diversify into most other businesses so long as the new activities were carried out through subsidiaries.

Institutional development

The government moved quickly and decisively in divesting SCT's major operating function to Telecommunicaciones de Mexico, a new, commercially oriented public agency, thus permitting the ministry to concentrate on regulating the sector. But the idea of creating a separate well-staffed and autonomous regulatory agency was not pursued in the short run. Interviews conducted during the audit suggest at least two possible explanations for this decision. First, Mexican officials were trying to reduce the size of government, and the creation of an autonomous regulatory agency for telecommunications might have sparked demands for similar agencies from other ministries. Second, there was concern that such an independent

November 1995
Performance indicators for Telmex, 1988–93

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<td>Telephone density (lines per 100 pop.)</td>
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<td>Capital expenditure ($ million)</td>
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<td>1,967</td>
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<td>Employees (telephone service only)</td>
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<td>Employees per 1,000 lines</td>
<td>11.7</td>
<td>10.5</td>
<td>9.6</td>
<td>8.5</td>
<td>7.5</td>
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<td>Taxes paid to government ($ million)</td>
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<td>1,293</td>
<td>1,301</td>
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Agency would lack the power to enforce its role.

Nevertheless, regulatory issues are now being handled reasonably well in the sector, for three reasons: (1) the high level of competence of some key Mexican officials associated with the reforms, (2) the involvement of a number of experts in conducting background studies and providing advice, and (3) the growing number of private firms entering the industry, which have begun to provide valuable checks and balances on each other.

Outcomes

Demand. Privatization of Telmex brought about positive changes across almost all performance indicators (see table). As required under the concession agreement, the company expanded the number of lines in service by 12 percent or more in each of 1991, 1992, and 1993, compared with 7 percent in 1988. And telephone coverage reached 8.7 lines per 100 people in 1993 compared with 5.6 lines in 1988. The company met its goal of two public telephones per 1,000 population in 1993, a year ahead of target.

Pricing. Rates were increased and rebalanced prior to privatization. Under the price-cap system put in place in 1991, average rate increases have been kept slightly below inflation. Subsidization of local service by long-distance service has been significantly reduced, with the sharp increase in local rates. But in 1994, businesses (which paid a $940 installation fee—lower than before, but still excessive) continued to subsidize residential users (who paid a $540 fee).

Returns to government and investors. As a result of privatization, both the government and investors gained. The government realized more than $6 billion from the sale of its holdings in Telmex. In 1993 revenues from Telmex in the form of telephone tax, income tax, value-added tax, and dividend withholding tax amounted to $1.75 billion, estimated to be an increase over revenues before privatization. Some investors also profited handsomely from the sharp run-up in stock prices after privatization.

Labor productivity. Although Telmex’s network expanded by 42 percent during 1991–93, employment in telephone operations actually fell by 2.3 percent (from twelve employees per 1,000 lines in 1988 to seven employees in 1993). Part of the decrease came through attrition—part through laying off nonunion workers, including some 350 senior managers. The company sees further productivity gains ahead as the need for services of operators and repair technicians declines.

Service quality. In one important respect, however, the company
lagged. Service quality continued to draw complaints, particularly in Greater Mexico City. In 1992, Telmex averaged a million customer complaints per month. In the worst month of the 1993 rainy season, one in nine telephones was out of service, compared with a target of one in seventeen. In hindsight, linking price increases to quality improvements might have improved service more quickly. Since 1993, however, Telmex has launched an aggressive campaign to improve quality and has taken steps to modernize and upgrade its equipment.

**Trucking deregulation**

*Approach*

The government feared that in the absence of competition, deregulation would result in sharp increases in transport rates. It therefore chose to deregulate the trucking industry in three stages to allow time for competition to develop.

- In July 1989, the government negotiated a pact with the trucking association under which truckers agreed to cooperate in the deregulation.

- Immediately following stage 1, the government issued a decree eliminating many restrictions on entry into the trucking business and abandoning the notion that trucking operations would require a concession.

- In January 1990, the government issued a decree abandoning tariff ceilings and thus freeing truckers to set their own rates.

Mexico’s three-stage approach to trucking deregulation appears to be replicable in other countries where trucking is heavily regulated and the degree of potential competition uncertain.

**Outcomes**

The deregulation of the trucking industry had a major positive impact on Mexico’s economy. Among the outcomes:

- Many new truck operators entered the field. By the end of August 1990, about 51,000 federal trucking permits had been issued, of which 30,000 were for new entrants and 14,000 for previously illegal operators.

- Tariffs for trucking services fell—by 23 percent in real terms during 1987-94. The Ministry of Trade and Industrial Development estimated that general distribution costs in real terms during the same period dropped 25 percent.

- Service improved in frequency, access, and speed of delivery.

- More flexible pricing of both truck and rail transport increased competition in the transport industry and helped to lower overall transport costs.

**Sustainability**

Because of strong government commitment, reforms in telecommunications and road transport are likely to be sustained. In telecommunications, the number of private firms involved in nonbasic services has increased, and these firms have a vested interest in keeping the sector open. Telmex’s monopoly on local and long-distance service will end in 1996, opening the way for yet more competition. In road transport, solid evidence of the benefits of deregulation helps bolster the sustainability of that policy.

**Conclusions**

- The outcome of Telmex’s privatization has so far been largely positive. The government and investors made substantial profits; consumers benefited by expanded service (although the quality of service remained poor and has only recently started to improve in some parts of the country), labor productivity increased, modern technology was introduced, and several companies stand ready to enter the long-distance sector once Telmex’s exclusivity ends.

- The success of privatization and deregulation provided significant opportunities for reducing cost and improving service in both sectors. Given Mexico’s experience, the Bank should continue to emphasize policy support for privatization and appropriate regulation (both formally and informally), as well as traditional project lending.

- In both sectors, structural reforms changed the nature of regulation. In telecommunications, regulations on price and quality and policies promoting competition became important issues. In transport, economic regulation gave way to environmental and safety regulations.

- The Mexican experience in privatization of telecommunications and deregulation of trucking demonstrates the critical importance of borrower ownership in the success of Bank support to public sector reform.