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A PRO-MARKET AGENDA FOR EL SALVADOR

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A Pro-Market Agenda for El Salvador

Eduardo Engel

Abstract

This paper argues that, despite important productivity gains, reforms have benefited consumers much less than expected in El Salvador. Antitrust legislation, consumer protection and an adequate regulation of privatized utilities are central ingredients of a successful market economy. Major reforms that are needed in each one of these areas in El Salvador are described.

Keywords: Market reform, Antitrust legislation, Consumer protection, Privatization, Regulation of utilities

JEL Codes: D18, L40, L51, L94, L96, O12

1. Introduction

El Salvador's economy went through major changes during the last decade. Trade was liberalized, the financial sector was deregulated and the banking sector was privatized. A tax reform that broadened the tax base and led to a significant increase in tax collection was put in place. Private participation in the energy and telecommunications sectors increased dramatically. A monetary integration law ('dollarization') was passed, and the pension system was reformed from a 'pay-as-you-go' to a fully funded system.

Payoffs from the above mentioned reforms are evident. Access to credit increased significantly, both for firms and for consumers. The country achieved investment grade, helping firms finance new investment projects with loans at lower (and more stable) interest rates. At the same time, an increasing number of families can finance their homes via long maturity loans with low interest rates, thanks to a fast developing mortgage market.

Another illustration of the positive impact of reforms can be found in the telecommunications sector, in particular in the mobile phone segment. Thanks to an active role of the regulatory agency, there are four mobile phone companies competing in this market, with a variety of technologies and pricing strategies. The government recently auctioned a fifth mobile telecommunications broadband for US$25.5 million. El Salvador has more than 800,000 mobile phone subscribers. Quality of service, compared with other countries, is generally good. Prices also are in line with those in other countries in Latin America. All of this has resulted in many families in the countryside having access for the first time to a telephone, allowing them to keep in touch with family and friends throughout the country (and the United States) at a much lower cost than they could have dreamed of a decade ago.

Yet the general mood vis-a-vis the reforms put in place during the last decade is negative. A general *malaise* is evident across all sectors of society. As shown in Table 1, the fraction of Salvadorans supporting privatization of public utilities decreased from 52.8% in 1998 to 25.1% in 2001. Since privatization was only beginning in 1998, the relatively high support that year possibly reflects what people expected from privatized public utilities. The dramatic decrease in support between 1998 and 2001 would then be due to people's disappointment with the results of privatization — El Salvador went from being the 3rd country with highest support for privatization in 1998 to position 10 (out of 17 countries) in 2001 (Table 1).[1]

[1] There is an overall decrease in the support for privatization across Latin America (Table 1), which may be due, at least in part, to cyclical factors. Yet support in El Salvador also fell when compared to the region's average, from 5.6% above the mean in 1998 to 4.5% below the mean in 2001.

Table 1: SUPPORT FOR PRIVATIZATION IN LATIN AMERICA (%)

	Argentina	Bolivia	Brazil	Colombia	Costa Rica	Chile
1998	39.5	52.2	49.1	39.6	58.7	50.3
2001	17.5	24.3	48.9	13.2	30.7	42.7
	Ecuador	**El Salvador**	Guatemala	Honduras	Mexico	Nicaragua
1998	51.7	52.8	61.5	46.4	49.7	45.6
2001	33.2	25.1	21.8	21.3	28.5	31.3
	Panama	Paraguay	Peru	Uruguay	Venezuela	*Average*
1998	20.3	46.4	43.5	43.5	51.2	*47.2*
2001	36.7	33.9	22.4	22.7	48.8	*29.6*

SOURCE: LatinoBarometro. The question those surveyed were asked was: *Do you (a) strongly agree, (b) agree, (c) disagree, (d) strongly disagree with the statement "the privatization of public utilities has been beneficial for the country".* Possible answers: the four options above and (e) do not know, (f) does not respond. Reported: percentage of individuals that chose options (a) or (b).

Discontent with privatizations (and, more generally, with economic reforms) seems to be broad based. Interviews with opinion leaders suggest high levels of dissatisfaction with electricity and telephone services across the board. Also, support for privatized public utilities in 2001 is low across all income groups, with no statistically significant differences across quintiles (Table 2). This is noteworthy, since higher income groups showed much more support for privatization before the process began in 1998 (Table 2); it follows that disappointment with the results of privatization is largest among middle and high income individuals.

The main theme of this chapter is that, despite important productivity gains, reforms have benefited consumers much less than expected. Put in a somewhat oversimplified manner, El Salvador made markets work; now the time has come to make markets work for everybody. Antitrust legislation, consumer protection and an adequate regulation of privatized utilities are central ingredients of a successful market economy. Major reforms are needed in each one of these areas. The time has come to focus on developing institutions that legitimize the market economy.[2]

There is a fundamental tension underlying any market economy. On the one hand, everybody is a consumer, standing to benefit from competition. More competition leads to better quality goods at lower prices, as illustrated by the mobile telephone example mentioned above. At the same time, everybody is a producer of goods and services, and in that role would like to have as little competition as possible. Workdays would be less stressful and remunerations higher if we faced no competition. You cannot have both, societies must choose between competition and monopolies. The central tenet of this chapter is that competition must prevail, for otherwise reforms are likely to be overturned at some point in the future. Citizens benefit from market-oriented reforms when competition is allowed to prevail.

[2] 'Market supporting institutions' in the (Rodrik, 2000) terminology.

Table 2: SUPPORT FOR PRIVATIZATION IN EL SALVADOR BY INCOME QUINTILE (%)

	Poorest quintile	Next 20%	Middle 20%	Next 20%	Richest 20%
1998:	43.5	37.7	46.2	65.7	77.1
	(3.5)	(3.4)	(3.5)	(3.3)	(3.1)
2001:	22.5	26.1	25.0	23.8	27.3
	(3.0)	(3.1)	(3.1)	(3.0)	(3.2)

Reported: As in Table 1, but disaggregated by income quintile and only for El Salvador. Standard deviations in parenthesis.

Fostering competition means having a well functioning antitrust legislation, which deters anticompetitive behavior, both by firms and by the government. Seven initiatives for legislating on this topic have been considered by the Salvadoran congress during the last decade, none of them was passed. Fostering competition also means having a modern legislation that protects consumers in the market place, very little of which currently exists in El Salvador.

Network industries, such as electricity and telecommunications, are fertile ground for the exercise of monopoly power. Some segments are natural monopolies and need to be regulated. Others, as we have learned over the last two decades, are amenable to competition, but require an active role by the regulator to avoid that players in particular segments of the market ('bottleneck facilities') exert market power. (Newbury, 1997) and many others since him, have pointed out that regulations determine the extent to which the efficiency gains that come with privatization of public utilities are passed on to consumers via lower prices. Regulation of privatized public utilities has been weak in El Salvador. For example, exertion of market power by one major player is the most plausible explanation for an increase of more than 200% in the price of electricity generation in early 2000. It took three additional years and an electoral defeat to have the governing coalition approve major changes of the regulation of the electricity market. Even though less dramatic, there also are important regulatory challenges facing certain segments of the telecommunications market.

An alternative way of viewing the main message in this chapter is that it emphasizes the important distinction between a pro-business and a pro-market agenda.[3] Often leaders that favor market reforms believe that any policy good for business must be good for the country as well. This is not true.

A manager may create value for company owners by finding new markets, developing new products and increasing productivity. He may also create value by lobbying the authority for policies and regulations that benefit his company, often to the detriment of potential competitors. From the point of view of company owners, both approaches to creating value are equally valid, yet from the point of view of society, the first alternative is much more attractive than the second one, since it adds value to the entire nation, while the second alternative does not.

[3] *The Economist*, June 26, 2003.

It is therefore important that the authorities provide an environment that fosters creativity over lobbying, development of new products over anticompetitive behavior, and search for new markets over ripping off consumers. Well designed antitrust and consumer protection legislation, combined with adequate regulation of the utilities markets, are a central part of such an environment.

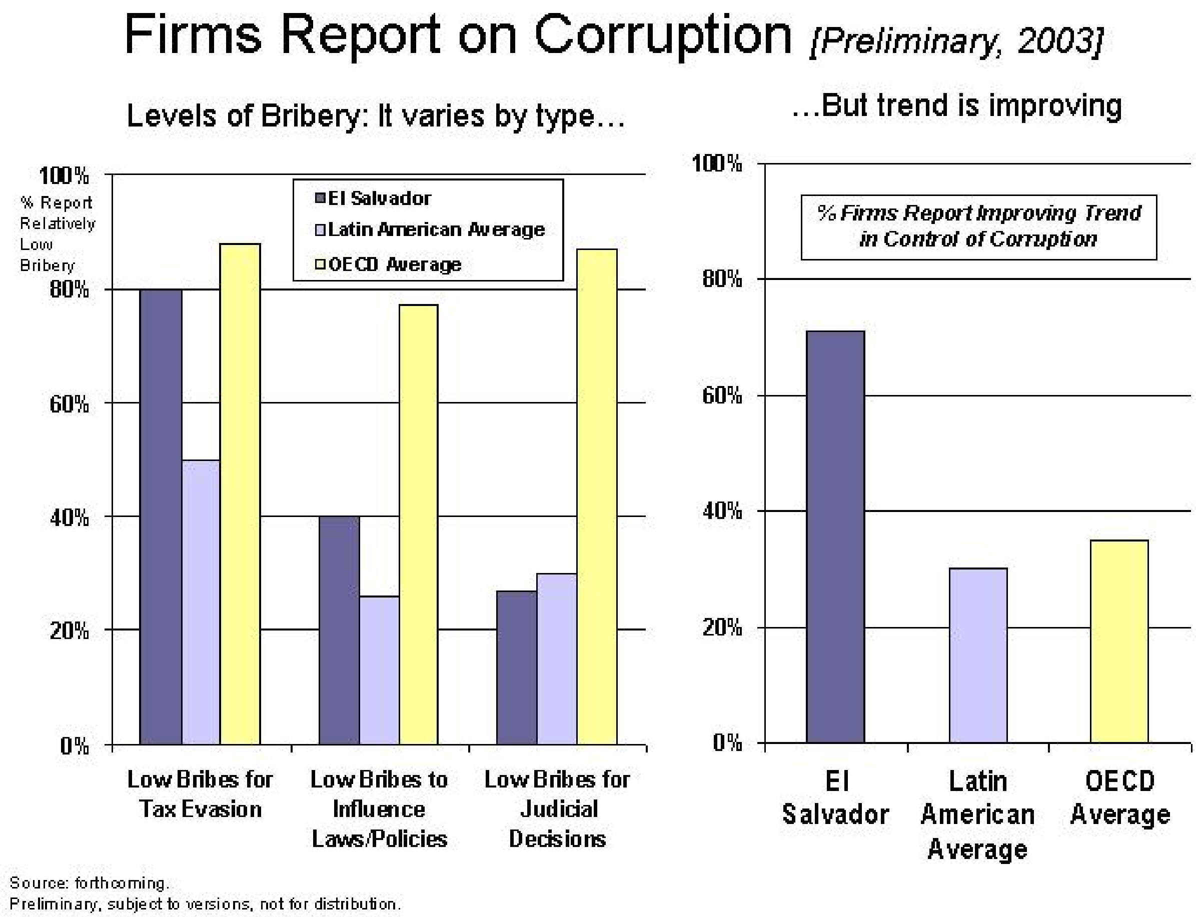

Figure 1

Figures 1, 2 and 3 provide some evidence on governance indicators for El Salvador.[4] For the sake of comparison, it also provides the average value for Latin America and the Caribbean (LAC) and OECD countries (Figures 2 and 3, respectively).[5]

Firms' assessment of different issues varies significantly. No bribes for imports/exports, no bribes for tax evasion and no bribes for procurement are issues where El Salvador ranks well in absolute terms, significantly better than the rest of Latin America, and pretty close to OECD

[4] "Governance" defined as "the traditions and institutions through which authority is exercised in a society".

[5] The connection between these indices and the extent to which a market economy fosters economic growth and development is well documented (see, for example, [Kaufmann and Kraay, 2003]).

levels. By contrast, when it comes to parliament effectiveness, trust of politician's honesty, independence of the judiciary and no undue influence of conglomerates, El Salvador ranks poorly in absolute terms, close the Latin American average, and considerably below OECD levels. Finally, it is interesting to note that firms perceive an improving trend in the control of corruption (Figure 1).

Discontent with privatization precludes the possibility of increasing private participation in sectors where it is badly needed. For example, investments of more than $2.2 billion are needed in highways during the next decade (Fusades, 2003b). Major investments in water systems and seaports are also needed. Yet fiscal constraints (see the chapter by Velasco in this report) imply that the government can finance only a fraction of these investments. Attractive alternatives, such as having the private sector finance some projects via Build-Operate-and-Transfer (BOT) concession contracts, may become politically viable once the agenda set out in this chapter is put in place. Legitimizing the market economy opens the possibility for further pursuing market-oriented reforms.

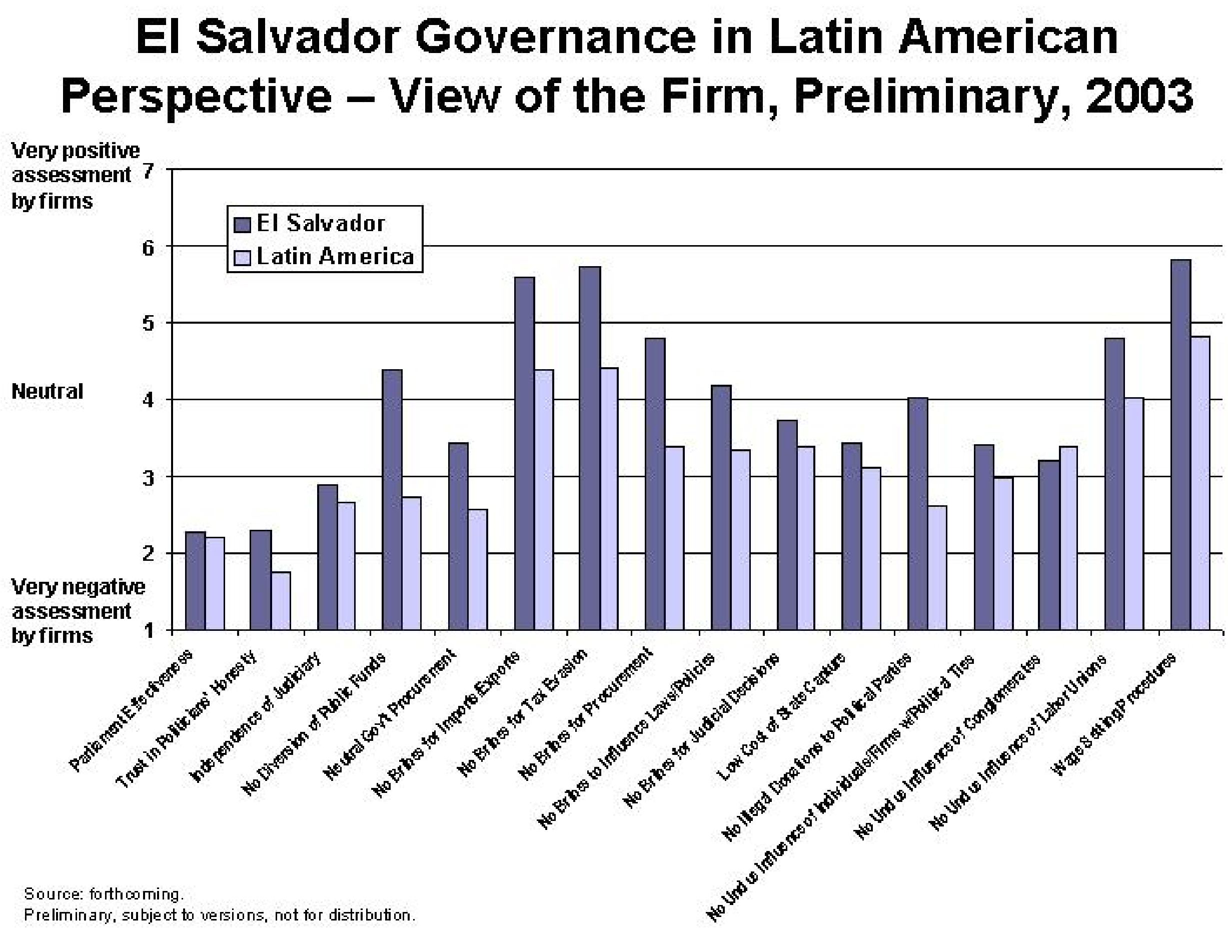

Figure 2

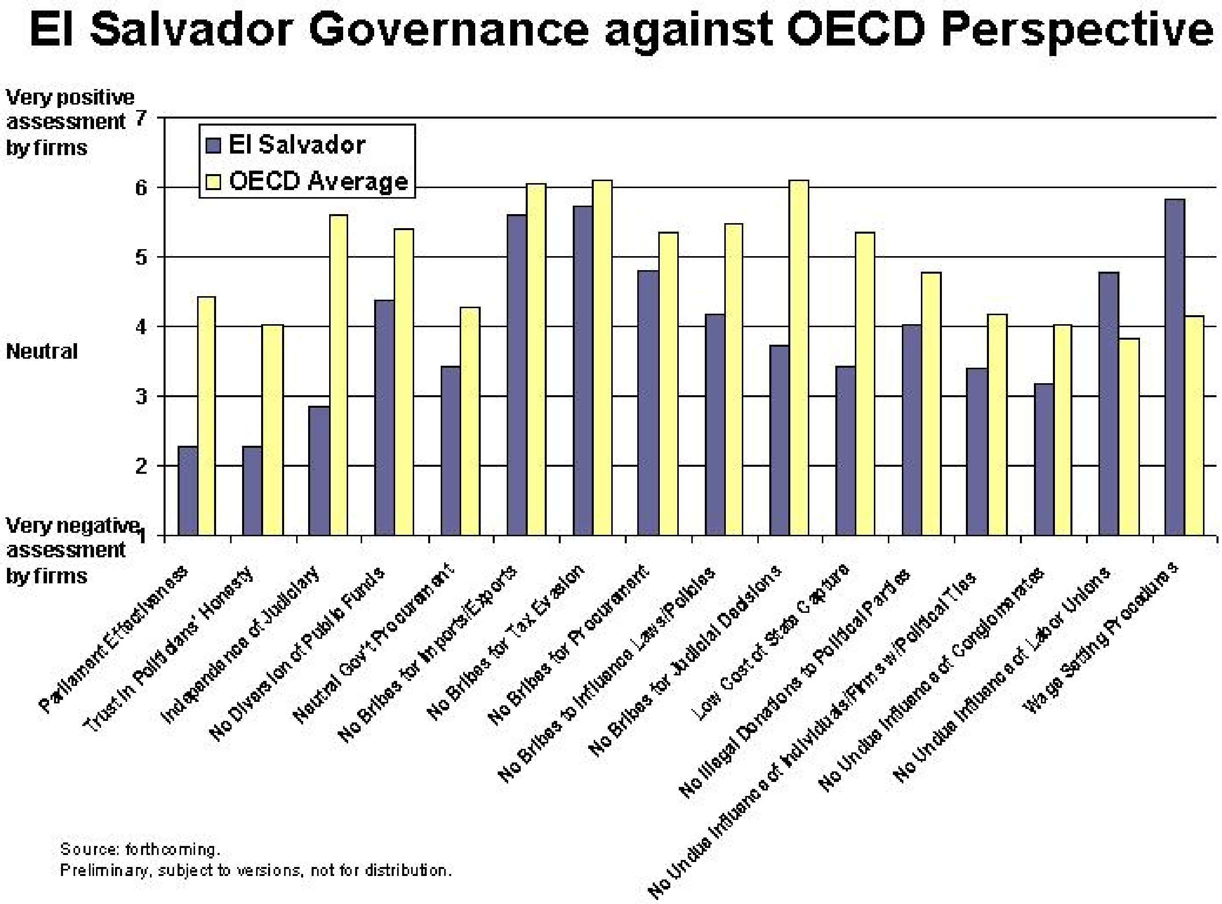

Figure 3

The remainder of this chapter is organized as follows. Section 2 considers competition policy while Section 3 analyzes consumer protection policies. Sections 4 and 5 look at the electricity and telecommunications sectors. Section 6 concludes, summarizing the chapter's policy recommendations.

2. Competition Policy[6]

An increased interest in competition policies followed the process of economic reforms and economic liberalization undergone by Latin America during the 1990s. In the case of El Salvador there were seven attempts at passing a competition law, none of which succeeded. In this section we review the main considerations to keep in mind when designing laws and institutions to support competition.

[6] This section benefited from comments by Ana Julia Jatar. It also is based in part on (Khemani and Dutz, 1995) and (Boner, 1995).

Competition policy includes (a) policies that enhance competition both in local and national markets (such as liberalized trade policy and economic deregulation), and (b) competition law (also referred to as antitrust or antimonopoly law) designed to prevent anticompetitive business practices by firms and unnecessary government intervention in the marketplace.[7]

Trade liberalization plays a major role in fostering competition in markets for goods and services with low transport costs ('tradable' goods). Indeed, trade liberalization has led to important reductions in prices across a wide variety of goods and services. Even in markets with a dominant firm both before and after liberalization, the threat of imports that results from trade liberalization may limit market power significantly. This provides an argument in favor of further reducing tariffs for consumer goods, which are still relatively high in El Salvador (typically 15%).

Trade liberalization, even though arguably the main component of a competition policy, is not enough. First, there are non-tradable goods, which requires appropriate regulatory institutions (more on this later in this chapter). Second, firms both in the traded and non-traded sectors may incur in anticompetitive conduct (e.g., collusive agreements). Third, government policies may deter competition.

Some interesting lessons have emerged from developing country experiences reforming their competition laws after undergoing market-oriented reforms. We discuss the most important ones in what follows.

2.1 Structure or Conduct?

There is general agreement that anticompetitive conduct, such as price fixing and other collusive agreements, must be punished by the competition authority. Yet such conducts are often not easy to prove in court, unless a 'smoking gun' can be found, or one of the participants in the collusive agreement is prepared to testify. It is therefore important to include a provision in the competition law offering participants immunity for cooperation in uncovering and prosecuting anticompetitive behavior.[8]

There is less agreement on the extent to which high concentration ('structure') in a given market should lead to actions by the competition authority. The problem is that often market concentration may have nothing to do with collusive behavior. If the economy is relatively small, as is the case of El Salvador, and economies of scale matter, then the result of competition may well be a market with few participants.[9] For this reason the competition law should be tolerant toward issues of market structure, while emphasizing anticompetitive behavior. This is particularly relevant when evaluating mergers and acquisitions.

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[7] (Khemani and Dutz, 1995).

[8] Unfortunately, such arrangements may run counter to the legal tradition in Latin America.

[9] The issue, of course, is that markets with few participants may or may not be collusive, which brings us back to the issues considered in the previous paragraph.

BOX 2.1 (Supermarkets and their providers)

In recent years, in many countries, providers of supermarkets have increasingly complained that they are being squeezed to the limit, with supermarkets imposing increasingly higher discounts, longer payment lags and other measures. This has often led providers to demand the intervention of the competition authority. Is such an intervention justified?

An often relevant issue is whether contracts are being abided by or not, yet this is not an issue that should concern the competition agency. The central issue from an antitrust point of view is whether the low prices that supermarkets are forcing upon providers are being passed on to consumers or not. If competition among supermarkets is fierce and the circumstances described above translate into lower prices for consumers, then the competition agency should not intervene. By contrast, if lower prices are not passed on to consumers, then supermarkets are abusing their dominant position at the expense of consumers and should be held accountable under anti-trust law. ■

2.2 The Protectionist Risk

Competition policy is sometimes used to protect inefficient firms within a country. For example, the competition authority might intervene to favor small and inefficient firms when they feel threatened by larger and more efficient competitors. Similarly, anti-dumping laws, which are part of competition policy, are sometimes used by local producers to avoid competition from more efficient competitors abroad.

In cases such as those described above, the competition authority must keep in mind that its main concern is consumer welfare, both in the present and in the future. Thus if the entry of new firms into a market is likely to lead to lower prices and better products, now and in the future, consumer welfare will increase and intervention is not justified.

2.3 Advocacy

An important role of the competition authority is to advocate the elimination of regulations that impede competition and often act as barriers to entry. The competition authority should also play a role analyzing government action to avoid decisions and legislation detrimental to competition.

For example, farmers producing milk may ask the government to intervene because the milk industry is paying them prices they consider too low. An appropriate intervention by the government is to ask the competition authority to decide whether there is evidence of collusive (monopsonistic) behavior in the milk industry. Yet often governments sponsor conciliatory meetings between both parties instead. A typical outcome of such meetings is an agreement between farmers and producers on the price at which the former will sell their milk to the latter. Thus the government ends up promoting a price-fixing agreement detrimental to consumers. The competition authority should act to stop this kind of agreement.

For the competition authority to undertake its advocacy role effectively, it is important that the competition agency have the economic and human resources necessary to do its job. Legislation should also support this role, in particular, the competition authority should be independent from the government.

2.4 Barriers to Entry and Distribution Channels

High levels of vertical integration toward distribution channels often act as important barriers to entry. This is particularly true in Latin America, where the absence of independent distribution channels often reduces the benefits for consumers from economic liberalization, since local producers end up becoming the distributors for their potential competitors. This has been observed especially in the case of massive consumer goods, and should be kept in mind when evaluating exclusive distribution contracts and mergers that include distribution assets.

BOX 2.2 (The Case of Fertilizers)

"Why should El Salvador pay much higher prices for fertilizers than neighboring countries? We are going to really open our boarders, so as to have competition and lower prices" said President Flores when inaugurating the agricultural year in May of 2003.[10] *"The way to break up a cartel is introducing competition" added Agriculture Minister Salvador Urrutia when asked whether high fertilizer prices were due to a cartel of importers.*

For many years there have been increasing complaints about anticompetitive behavior in El Salvador's fertilizer market. Prices paid by El Salvador farmers even today, after many attempts by the government to solve the problem, may be as much as 34% higher than in neighboring countries. Since fertilizers are an important input in agriculture, paying a higher price is a major obstacle to develop this sector.

A week after making the statement above, the Agriculture Minister announced an agreement with importers of fertilizer that fixes the price of two broadly used fertilizers at a price somewhat below its previous price.[11] *That is, instead of dealing with the underlying problem, namely the lack of competition in an important market for El Salvador's economy, the government ended up putting in place a price-fixing agreement. Prices paid for fertilizers by farmers are likely to continue being above what they would be under competition.*

The correct approach would have been to look at the barriers to entry in the fertilizer market. Press reports suggest some obvious candidates. First, a series of non-tariff barriers for importing fertilizers, especially for new market participants. Second, a powerful lobby of local fertilizer producers, who benefit from having less competition from importers, since this allows them to sell their production at a higher price.

This example also illustrates that competition policy may promote competitiveness, by fostering low input prices in important sectors of the economy. ■

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[10] *El Diario de Hoy*, May 6, 2003.
[11] *El Diario de Hoy*, May 10, 2003.

3. Consumer Protection[12]

Consumer protection policies are designed to protect consumers from physical or financial damage that may result from personal or household use of goods and services. Their aim is to support households in their effort to utilize their resources in an efficient manner. These policies influence the information available to consumers when they make a purchase, the skills they possess to process this information, the likelihood that the good they bought results in physical damage, and the avenues open to obtain redress should they be dissatisfied with the purchase.

3.1 Why Consumer Policies?

Markets may fail to develop in the absence of adequate consumer protection. For example, the fish market requires distribution channels that ensure adequate refrigeration, the market for bank deposits is fostered by prudential supervision of banks and government insurance of deposits. In general, the main problem faced by consumers is that of "hidden quality" (the economic concept is 'asymmetric information'). Consumers and producers often know more about the good they sell than potential buyers, which frequently leads to consumer disappointment and overall frustration with the market economy.

One justification for consumer policies is that the information needed for buying goods and services often is not easily available. This information must be generated by someone, which entails a cost. It also has to be assimilated by consumers, which is more likely to happen when consumers are educated and the information is easy to understand.[13] Furthermore, often the person that possesses information on a product does not have incentives to provide this information to consumers, leading to the above mentioned 'hidden quality' problem, and a second justification for consumer policies.

A third justification, unrelated to informational problems, is the high costs associated with organizing consumers. Small groups of individuals with common interests, such as producers within a specific sector, face much lower costs organizing to defend their interests than do large groups of individuals, such as consumers.[14]

One of the groups that stands to benefit most from consumer protection policies are the most vulnerable sectors of society, since they typically possess fewer of the skills needed to function in a market economy. In a country without adequate consumer protection policies, the poor not only face the problems associated with having low incomes, but also obtain less value for their money.

Consumer policies also lower the cost at which firms can inform consumers of their products. Since the quality of goods increases with the number of well informed consumers,[15] consumer

[12] Based on interviews conducted by the author and (Engel, 1995, 1998).
[13] (Simon's, 1955) 'limited rationality' concept underlies this idea.
[14] This corresponds to (Olson's, 1965) 'logic of collective action' argument.
[15] (Tirole, 1988, p. 107) presents a simple formalization of this idea.

protection policies improve the overall quality of goods in the economy, benefiting producers of high quality goods and all consumers (independent of how well informed they are).

Consumer protection policies also increase a country's competitiveness. As argued by Michael Porter, without demanding consumers and well functioning markets, it is difficult for domestic firms to develop the ability and experience to compete in foreign markets. More demanding consumers help local industry try out new products and explore new business opportunities at home, thereby reducing investment risk.

3.2 Consumer Policies

The market economy solves asymmetric information problems when producers have incentives to provide truthful and timely information to consumers. When such incentives are not present, regulation is often justified. The following classification of consumer goods helps distinguish between markets where regulation is necessary and those where it is not.

Search goods are those whose quality can be evaluated before buying them. A postcard, stamps and certain characteristics of clothing belong to this category. It suffices to examine these goods to determine their quality before buying them — the hidden quality problem is not relevant in this case. For search goods, consumer policies should focus on providing information on prices and where products are sold. Price surveys are useful in this case.

Credence goods are the opposite of search goods. With credence goods, it may take a long time before consumers find out what they really bought. Sometimes they never find out. Fire extinguishers, whether a house is earthquake proof, or whether a medical intervention was timely, belong to this category.

The market test is not enough to ensure adequate levels of quality and safety for credence goods, since the possibility of bankruptcy does not provide sufficient incentives to avoid undesirable commercial practices.

In the case of credence goods, governments use a combination of legislation (e.g., tort law) and regulations to protect consumers. The latter include compulsory quality standards and restrictions on who can provide certain goods or services.

Finally we have *experience goods*, the quality of which is learned through use. Cars and durable goods belong to this category. When consumers have easy access to information about the quality of these goods, as is the case when they buy the good often enough, producers have incentives to provide good quality, since consumers will reward them by purchasing their product again. Even in the case of goods that are bought infrequently, word-of-mouth may be enough for markets to function well.

Yet for complex goods that are bought infrequently, consumer protection policies help both consumers and high quality producers. Buying a house or choosing an insurance company when retiring from a private pension fund are often once-in-a-lifetime decisions where adequate regulations help consumers mitigate the hidden quality problems.

The laws and agencies that impact consumer policies are many. Both the civil and penal codes are relevant, and most countries, including El Salvador, have a separate Consumer Protection Law. Many consumer issues are covered by other laws as well. And even though most developing country governments have a Consumer Protection Agency, this usually is not the only government agency dealing with consumer issues. For example, regulatory institutions in charge of utilities and financial services also play a role in consumer issues.

The activities conducted by consumer protection agencies can be classified into the following four categories:

3.2.1 Information

Agencies generate information that is useful for consumers. This may include price surveys, leaflets educating consumers about specific markets, results of product testing, publication of a consumer magazine, promoting standards, etc.

Consumer policies often faces the trade-off between simplifying customers' information processing, and limiting their freedom of choice. Standardization helps consumers who have a hard time evaluating complex products, yet it hurts those who have the skills to process complex information and would benefit from having more variety to choose from. There are many cases where the benefits of standardization outweigh its costs. For example, having car sellers list in a standard format the duration and kind of warranty, if any, that various car parts are under.

Another example where standardization is beneficial is when supermarkets are required to label their goods not only with their price but also with their *unitary* price, that is, the price per some standard unit (e.g., kilogram or liter). Such labeling helps consumers compare prices and promotes competition. The cost of providing this information is so low that, even if only a fraction of consumers benefit from it, the benefits definitely outweigh the costs.

BOX 3.1 (Providing product information)

On September 14th 1991, Chile's consumer protection agency (SERNAC) published an article entitled "All about Sausages and Hams," showing the results of laboratory analysis carried out on two kinds of sausage — the tasty Longaniza *and the hot dog* Salchicha *sausage — and on cooked ham. The samples were taken directly from the factories or storage centers and sent to the Public Health Institute for analysis, without labelling of their origin.*

All the Longaniza sausages analyzed (26 brands) exceeded the limits set for the total micro-organism count. The presence of staphylococcus aureus was detected in 22 of the brands, and salmonellas in 14 samples (the total absence of these micro-organisms is stipulated). As regards the Salchicha type used in hot dogs, 9 of the 22 brands studied exceeded the permitted levels of micro-organisms. In addition, all but one exceeded the limits set for polyphosphate, an additive that fixes water and, when used in excessive quantities, makes the product swell. The main problem with the hams was not bacterial contamination (only four of the 23 brands breached the permitted limits) but, as with the hot dog sausage, excessive addition of polyphosphate in all but one of the brands.

The immediate reaction of consumers was to drastically cut back their consumption of all types of processed meat, not just those considered in the study. This led the National Processed Meat Industries Association (ANIC), which includes four firms producing 70% of national processed meat, to commission the prestigious Fundación Chile foundation to certify the quality of processed meat. Another processed meat firm which was not a member of ANIC placed advertisements in the press announcing that SERNAC had ratified the quality of its products, which indeed it had. In the end, the processed meat study resulted in the introduction of vacuum wrapping technology in most factories, thereby avoiding the main source of contamination, namely human handling of the product.

The outcomes described above are in line with the positive effect one expects from product studies: providing information to consumers so that they can better discern between different brands and choose those of better quality. Insofar as the dispersion of quality reported is greater than what consumers presume, bringing this information to light also leads industrialists (especially those producing lower quality goods) to improve product hygiene. In the end, both consumers and manufacturers of better quality products benefit. ■

3.2.2 Consumer Redress

Consumer agencies play an important role helping consumers obtain redress. This includes promoting conciliation between the consumer and producer without the need of going to court and, should this fail, helping consumers undertake legal action. It also includes taking a proactive role in cases that affect a large number of consumers, such as false advertising and collective action cases.

3.2.3 Legislation

Preparing and promoting both new consumer legislation and changes to the existing legislation.

3.2.4 Consumer Education

This role includes promoting the inclusion of consumer issues in the school curriculum, conducting talks for various groups of consumers, etc.

3.3 Consumer protection in El Salvador

The Peace Accords included provisions for the creation of a consumer protection agency, that eventually became known by its Spanish acronym of DPC (Dirección de Protección al Consumidor).

The DPC functions as a division of the Ministry of Economics. Its official functions are the following:

1. Plan actions and design policies oriented toward protecting consumers.

2. Monitor and supervise price behavior and compliance with quality, weights and measures, information to consumers, etc., of basic and strategic products sold in the domestic market.

3. Monitor the correct application of tariffs for essential services.

4. Apply measures to avoid the immoderate increase of prices, hoarding of goods, shortages, low quality and other undesirable business practices related to essential goods and the delivery of services to consumers.

5. Divulge the Consumer Protection Law.

6. Provide orientation to consumers regarding market conditions, so they can exert their rights and thereby contribute to a more stable and transparent domestic market.

7. Elaborate and develop consumer education programs.

8. Provide a service where consumers can file complaints for dissatisfaction with goods and services they have purchased and, more generally, information related to the Consumer Protection Law.

This list of objectives illustrates a certain degree of confusion regarding the role of a consumer protection agency in a market economy. Points 2 and 4 suggest a role for DPC controlling prices, an idea associated with consumer protection in highly regulated economies but not in a market economy.[16] The emphasis on basic and strategic goods in points 2 and 3 is also unwarranted in a market economy, since consumer protection should cover all goods and services.

Table 3: CONSUMER PROTECTION IN EL SALVADOR AND CHILE, 2002

	El Salvador	Chile
Yearly Budget (US$)	616,000	3,550,000
Complaints Processed	4,691	28,839

SOURCES: DPC (El Salvador) and SERNAC (Chile).

There is broad agreement in El Salvador that consumer protection legislation and the consumer protection agency are weak and, to a large extent, irrelevant. Table 3 provides some quantitative support to this assertion. It compares El Salvador's and Chile's consumer protection agencies on a number of counts. It should be noted that, compared with many countries in Latin America, Chile's consumer protection institutional framework is relatively underdeveloped (see Engel [1998] for a possible explanation).

If we consider that in Chile (a) consumer issues related to utilities are dealt mainly by the corresponding superintendencies while in El Salvador the DPC is in charge of them, and (b) in Chile there exists a Competition Agency in charge of issues for which the DPC is responsible in El Salvador, it becomes apparent that the DPC's budget is low compared to its sister institution in Chile, even after accounting for differences in population and GDP. This is confirmed when we

[16] By law, DPC is in charge of monitoring the only remaining controlled price in El Salvador's economy, that of liquified gas.

compare the number of complaints processed in both countries.[17]

The weakness of the consumer protection legislation in El Salvador is also illustrated by the fact that a fine can be charged only if a producer continues violating the law after having been admonished. That is, the sanction of first instance is only an admonition. Also, the magnitude of a fine cannot exceed the benefit obtained by the producer from violating the law, which runs counter to the basic principle that fines should be set high enough to provide incentives to behave according to the law.[18] Finally, the highest fine that can be charged is US$12,000, which may be very low compared to the damages caused by a producer and, again, provides poor incentives for compliance.

DPC has a user-friendly and well designed web page.[19] Consumers may file complaints through the web, yet this requires providing a telephone and an e-mail address. Therefore only high income consumers are likely to use this option.

The web page includes price surveys of basic consumer goods, yet the frequency with which these surveys are updated is relatively low.[20] The web page also includes a survey of mortgage interest rates.

DPC also plays a role setting standards regarding the information that should be included in bills paid by consumers for services such as credit cards and utilities (both private and public). Also, DPC recently signed an agreement with the state owned water company, ANDA, to help improve the quality of services provided by ANDA.

National coverage by DPC is limited. It has only four offices where consumers can seek advice and file complaints. Two of them are located in San Salvador (one of them specializes on financial services, being shared with the corresponding superintendency). The remaining two offices are located in the regional capitals of Santa Ana and San Miguel. This means that almost half the population does not have a DPC office within 15 miles. Consumers may also file complaints at the Ministry of Economics Infocentros, yet the low number of complaints actually filed suggests that these centers may not be a good substitutes for more specialized offices.

3.4 Policy Recommendations

The following policy recommendations follow from the discussion above:

1. The Consumer Protection Law should be revised. In particular, it should be modified so that violations can lead to immediate pecuniary penalties. Also, fines should exceed the

[17] We are ruling out the possibility that the small number of complaints filed in El Salvador reflects a high degree of satisfaction with consumer policies. The evidence presented in the remainder of this section justifies doing this.
[18] Since often violations of the law are not detected, this principle implies that fines should be set above the benefit obtained by trespassers (e.g., ‘treble damages’).
[19] The agency’s motto, according to its web page, appropriately reads *“informed consumers make competitive firms”*.
[20] On August 7, 2003, the last survey available on the web was two and a half months old. In other countries such surveys are conducted on a weekly (or at least monthly) basis.

benefits obtained from illegal conduct.

2. DPC's budget should be increased significantly and institutional changes granting DPC more autonomy (from the Ministry of Economics) and a higher profile should be put in place.

3. DPC's national coverage should be extended. One possibility is to work together with municipalities, an option that DPC has shunned because of concerns about politization of consumer issues.

4. DPC should test products and conduct market studies, both activities are currently almost completely absent. This should eventually lead to the publication of a consumer magazine.

4. Electricity Market[21]

4.1 Description

The electric sector in El Salvador has one of the most liberal regulations in the world. Both vertical and horizontal integration are allowed and contracts signed between agents are confidential.[22] Also, and possibly more important, the spot market for electricity generation is a real market, with prices and volume determined by the interaction of price bids by suppliers and demand on an hourly basis.

El Salvador's regulatory framework considers five types of market participants: generators, traders, transmitters, distributors and final consumers. Transmission and distribution fees are regulated, the remaining segments are almost entirely unregulated.

The generation market consists of two segments: the spot market (Mercado Regulador del Sistema, MRS) and the contracts market. The Unidad de Transmisión (UT), a private entity owned by generators, distributors, transmitters and large users, coordinates the generation market.

The conditions agreed upon in contracts are confidential, with the only requirement that contracted volumes be informed one day in advance. The spot market then operates as a surplus market, on the basis of price bids. Generators post the price at which they are prepared to generate energy on an hourly basis. UT coordinates generators' contribution to the system starting with the cheapest bid and moving upward until demand is satisfied. The price paid is that posted by the marginal generator.

The Superintendencia General de Electricidad y Telecomunicaciones, SIGET, is in charge of regulating the industry. SIGET was created as an autonomous legal entity, with its own budget

[21] Sources: (Arellano, 2003), (Fischer, 2000), (Fusades, 2003a, 2003b), (Salamanca, 2000) and interviews conducted by the author.
[22] This may change in the near future, see below.

and equity. The regulatory authority is appointed by the President. Transmission and distribution fees are regulated by SIGET, based upon the cost structure of an efficient firm.

An interesting feature of the system is that final users may sign contracts with distributors and traders that do not cover their geographic zone. Another is that the UT determines the party responsible for supply failures and imposes adequate compensation.

Current (2003) generation capacity is 1156.2 MW, which is 1.7% higher than in 2002. facing a maximum demand of 705 MW. Hydroelectric generation accounts for 38.6% of total capacity, thermal generation for 46.2% and geothermal generation for 15.1%.[23] The transmission network is 115 KV. An important US$72 million rehabilitation project of the transmission network was finalized in January of 2003. El Salvador is connected to Guatemala and Honduras through a 230 KV lines that transmit up to 120 MW, allowing both imports and exports of energy.

An ambitious interconnection project across Central America, known by its Spanish acronym of SIEPAC,[24] is expected to begin providing services in 2007. A subset of SIEPAC, known as MER (Mercado Eléctrico Regional), began operating on an experimental basis in September of 2002.

Table 4: INSTALLED CAPACITY ELECTRICITY GENERATION, IN MW. DECEMBER 2001

Firm	ROR	H-R	T	G	Cog	Total
CEL	157	239	0	0	0	396
GESAL	0	0	0	161	0	161
Duke	0	0	384	0	0	384
El Paso	0	0	145	0	0	145
Others	8	0	33	0	0	41
Total Wholesale	165	239	561	161	0	1126
Retail Market	3	0	26	0	36	66
Total	168	239	587	161	36	1191

Reported: ROR = hydro run-of-river, H-R = hydro reservoir, T = thermal, G = geothermal, CoG = co-generation.
SOURCE: (Arellano, 2003).

The generation segment consists of 6 firms that participate in the wholesale market and 8 smaller generators that participate in the so-called retail market. The most important participants in this segment are the state-owned companies CEL and GESAL and the private companies Duke and Nejapa Power (owned by El Paso). CEL has the largest installed capacity; all its plants are hydro centrals and 60% of its capacity comes from hydro reservoirs, which allow the exercise of market power.[25] Private participants Duke and Nejapa Power only own thermal plants. Table 4 shows installed capacity, by type of generator, as of December 2001.

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[23] Source: SIGET.
[24] Sistema de Interconección Eléctrica para los Países de América Central.
[25] The remainder of its capacity comes from hydro run-of-river generators, which cannot be used to exert market power.

The demand for energy in the wholesale market comes from 5 privately owned distribution companies and the large-consumer segment. With only one exception, all distributors are owned by the American company AES,[26] which accounted for 78% of total sales during 2001. The large-consumer segment has developed slowly, nonetheless it is the most developed market of its kind in Central America. Most traders are related to generation and distribution companies, independent traders began entering the market only recently.

4.2 Market Power Analysis

Since norms governing the electric sector in El Salvador are very liberal, particular care must be taken concerning opportunities to exert market power.

The degree to which a generator can exert market power depends on his market participation and the type of technology used. For example, a hydro-run-of-river generator has no ability to exert market power. By contrast, a hydro-reservoir generator and a thermal generator both have the possibility of exerting market power, the former by deciding strategically when to use the water in its reservoir to generate electricity, the latter by choosing when to turn on its generator. Keeping this in mind it follows from Table 4 that Duke, and not CEL, has the largest potential to exert market power, since an important part of CEL's generation capacity comes from technologies that cannot be used to exert market power. This is further compounded by the fact that CEL is government owned and, at least so far, there is no evidence of it exerting market power. By contrast, most independent analysts agree that Duke did exert market power during early 2000, in an episode that deteriorated public perception of privatized utilities significantly (see Box 4.1).

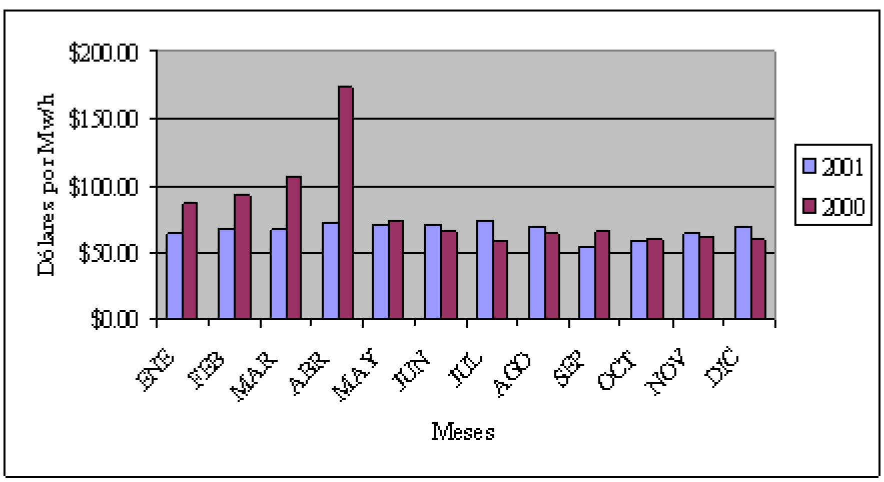

Figure 4: Spot prices in El Salvador's Electric Market. Monhly averages, years 2000 and 2001.

[26] As mentioned above, horizontal integration is allowed in El Salvador.

BOX 4.1 (Electric crisis of April, 2000)

During 1998 and 1999, the monthly average of the spot market price for electricity generation in El Salvador oscillated between $45 and $77 per MWh. Yet during the first months of the year 2000, this price began to increase, jumping to a maximum monthly average of $173.71 in April (see Figure 4 and Table 5). A major draught, possibly combined with suboptimal management by CEL of its water reservoir, exhausted CEL's ability to generate electricity before the rainy season began. This allowed Duke to set the market price substantially above its marginal cost, thereby tripling the price for electricity generation. This episode made evident the limitations of El Salvador's regulatory framework and, more generally, of regulatory frameworks with bid-based dispatch of electricity units. ■

Table 5: YEARLY AVERAGE SPOT PRICE FOR ELECTRICITY (USD/MWH)

Year	Mean	Max.	Min.	St. Dev.
1998	58.19	73.21	46.55	8.56
1999	63.95	76.81	56.92	6.37
2000	80.4	173.71	58.12	33.21
2001	66.7	73.61	54.53	5.8
2002	66.18	72.79	53.05	6.08
2003: 1-6	73.55	78.87	60.16	7.33

Max. and Min. correspond to the month with highest and lowest average price. St. Dev. is the standard deviation of monthly averages.
SOURCES: Unidad de Transacciones and SIGET.

It took almost three additional years and an electoral defeat in congressional elections for the government to push through Congress a reform aimed at dealing with the problem uncovered by the April 2000 crisis.

Legislative Decree 1216, modifying the General Electricity Law, was passed in April of 2003. This decree allows SIGET to intervene should it detect anticompetitive conduct in a relevant segment of the electricity market. Of particular importance is Article 112-E establishing that *"... as long as conditions guaranteeing healthy competition do not exist for prices in the spot market, determined objectively using international indices to measure market competitiveness, the UT will be governed by by-laws ('reglamento') that guarantee a behavior by suppliers similar to that in a competitive market..."* The set of by-laws is currently being prepared by SIGET, and will be based on firms' marginal costs, not price bids.

Article 9 of the decree allows SIGET a more active role obtaining information from companies when setting regulated fees for transmission and distribution. Article 11 gives SIGET the authority to obtain, from operators and the UT, the information it needs to do its job. It also allows SIGET to inspect companies to check the veracity of the information they provide. This provision had to be added because of the lack of cooperation of UT with SIGET in the past.

The degree of concentration in the distribution segment is also a source of concern since, as mentioned above, one participant accounts for 78% of the market. This is compounded by the absence of passthrough of energy purchase prices to final users and the confidentiality of contracts. The use of the spot market price for calculating the fee for final users leads distribution companies to negotiate "good" conditions when purchasing energy on the contract market in order to keep the difference. As long as the contract market and the spot market are not fully arbitrated, AES has incentives to exert monopsonistic power when buying energy. Confidentiality of contracts adds to the problem, since SIGET cannot monitor prices in order to determine whether competitive conditions are being met.[27] And since distributors can sell to users outside their geographic zone, this means that AES could potentially use its monopsony power to price out competitors from the entire large-consumer market. The potential for monopsonistic behavior by AES will increase when the "El Faro" project by AES in Honduras, and the line connecting this generator to El Salvador, start operating in the near future. AES then could be run as a vertically integrated company, exerting market power in the spot and large consumer markets.

4.3 Policy Recommendations

It is clear by now that the regulatory framework in the electric sector has not worked well. Yet before making any concrete recommendations, a detailed study of market power in the relevant segments of the market is needed. According to one expert interviewed for this project, such a study was commissioned by SIGET, uncovering major problems related to anticompetitive behavior. SIGET has not acknowledged the existence of such a report.

The reforms passed in April of 2003 point in the right direction, yet it is not clear whether they will provide a major competitive boost to the functioning of the electric market, or whether they will eventually be described as 'too little, too late'. For example, a major burden has been put on SIGET if it wants to change the way generation prices are set, since it must prove anticompetitive conditions. It would have been more realistic to abandon the current method and move to a cost based approach. On a more positive note, interconnection to Central America (SIEPAC project), which is expected to be in place in 2007, may foster competition.[28]

To give the recently approved reform its best chance, SIGET needs strong political support to take full advantage of the new possibilities opened by recent legislation. In particular, SIGET needs to be able to conduct studies of the degree of competition prevalent in segments of the electric market on a regular basis. This requires access to information on what, until recently, were confidential contracts. At the same time, a more active regulator requires more independence (insulation from political pressures) and accountability (disclosure justifying actions taken by the regulator).

Also, our analysis of the distribution market suggests that vertical and horizontal disintegration should be considered in the future. Likewise, the evolution of independent marketers should be followed closely. Their importance has grown recently, which should inject competition into the large-consumer market. Yet this needs to be monitored closely, with SIGET providing support for marketers should they face unfair business practices by the dominant firm

[27] This may change with the reforms put in place in April of 2003.
[28] Yet this raises the issue of regulating market power at the Central American level.

in that segment.

5. Telecommunications[29]

Telecommunications is an important sector of the economy, with implications both for firms' productivity and consumer welfare. Competitiveness in many branches of the service industry (e.g., banking and airlines) depends significantly on having well functioning, low priced telecommunications. Similarly, being able to keep in touch with relatives and friends that live in other cities (or, as is often the case in El Salvador, in other countries) also depends on having access to telephone services at a reasonable price.

5.1 Description

A new law liberalizing the telecommunications market was passed in 1997. This resulted in the sale of the state-owned incumbent, Administradora Nacional de Telecomunicaciones (ANTEL), in July 1998. ANTEL was divided in two parts. France Telecom bought the fixed telephone component plus a band B PCS license under the name of Compañía de Telecomunicaciones de El Salvador (CTE). The Spanish multinational Telefónica bought the wireless (long-distance) component with a celular band B concession giving rise to Telefónica El Salvador.

The main objective of liberalizing the telecommunications market was to increase access to telephone lines, which was at a relatively low level of 6.4 telephone lines per 100 inhabitants in 1998 (the corresponding number for mobile phones was 1.4). On this count the reform has been nothing short of a major success: The number of fixed telephone lines grew by more than 70% between 1998 and 2002. Furthermore, and unexpected at the time liberalization took place, the mobile phone market expanded at such a fast rate that the number of mobile phone subscribers surpassed that of fixed line subscribers. By 2002 the number of telephone main lines in use per 100 inhabitants has surpassed the 10% mark, the corresponding statistic for mobile phones was 13.8% (Table 6). It is also worth noting that, as shown in Table 7, most of the growth in fixed telephone lines was outside the metropolitan area (San Salvador).

Tables 8, 9 and 10 show that coverage, especially in the case of mobile phones, grew significantly across Latin America in recent years. When seen in this light, improvements in El Salvador are somewhat less impressive. Yet even on a comparative basis, El Salvador can report significant improvements. Coverage moved closer to the Latin American average between 1998 and 2002. In the case of fixed lines per 100 population, El Salvador moved from 56 to 75% of the regional average, while the number of mobile subscribers increased from 54 to 84% of the regional average. Improvements are more remarkable when compared with other countries in Central America.

[29] Based on (Fischer, 2000), (Fusades, 2003b), (Laffont and Tirole, 2000), (Noll, 2000) and interviews with industry specialists in El Salvador, Chile and the United States.

Table 6: TELECOMMUNICATIONS: COVERAGE, TRAFFIC, INVESTMENT AND PRICES

	1998	1999	2000	2001	2002
Coverage					
Fixed lines:	386,659	495,340	625,785	649,879	667,699
Mobile phone subscribers:	137,114	511,365	743,628	857,782	888,818
Internet users:	n.a.	n.a.	n.a.	n.a.	81,177
Traffic (MM minutes)					
Local:	46	2,787	3,346	3,492	3,564
National:	9	314	474	814	878
International:	262	452	849	960	908
Investment* (MM US$)	477.2	710.8	876.6	163.1	76.8
Prices (US$)					
Installation fixed line:	335.77	335.77	335.77	335.77	257.58
Fixed monthly fee residential:	6.84	7.13	7.13	8.12	8.35
Fixed monthly fee commercial:	13.69	14.21	14.21	14.21	12.72
Per minute local call:	0.0194	0.0201	0.0229	0.0229	0.0229
Per minute national:	0.0323	0.0336	0.0382	0.0382	0.0407
Per minute, fixed to mobile:	0.019	0.23	0.23	0.23	0.23
Per minute, to the US:	0.8	0.48	0.25	0.25	0.25

SOURCE: SIGET.
*: includes real estate and buildings.

Table 7: ACCESS TO FIXED LINES: METROPOLITAN AREA VS. INTERIOR

	Jul. 1998	2002
Metropolitan Area:	296,327	327,700
Interior:	91,217	339,999

SOURCES: (Fischer, 2000) and SIGET.

Table 8: FIXED LINES PER 100 INHABITANTS IN LATIN AMERICA.

	Argentina	Bolivia	Brazil	Colombia	Costa Rica	Chile
1998	20.9	5.7	12.1	15.6	19.3	20.6
2002	21.9	6.8	22.3	17.9	25.1	23.0
	Ecuador	**El Salvador**	Guatemala	Honduras	Mexico	Nicaragua
1998	8.1	6.4	4.8	4.0	10.4	3.0
2002	11.0	10.3	6.5*	4.8	14.7	3.2
	Panama	Paraguay	Peru	Uruguay	Venezuela	*Average*
1998	15.1	5.0	6.3	25.0	11.2	*11.4*
2002	13.0*	4.7	7.8*	28.0	11.2	*13.7*

Source: ITU.
*: information for 2002 not available, year reported is 2001.

Table 9: MOBILE SUBSCRIBERS PER 100 INHABITANTS IN LATIN AMERICA.

	Argentina	Bolivia	Brazil	Colombia	Costa Rica	Chile
1998	7.2	3.0	4.4	4.4	2.8	6.5
2002	17.8	10.5	20.1	10.6	12.7	42.8
	Ecuador	**El Salvador**	Guatemala	Honduras	Mexico	Nicaragua
1998	2.0	2.3	1.0	0.6	3.5	0.4
2002	12.1	13.8	9.7*	4.9	25.5	4.5
	Panama	Paraguay	Peru	Uruguay	Venezuela	*Average*
1998	3.1	4.4	3.0	4.6	8.6	*3.6*
2002	16.4*	28.8	8.6	15.5*	25.5	*16.5*

Source: ITU.
*: information for 2002 not available, year reported is 2001.

Table 10: INTERNET SUBSCRIBERS PER 100 INHABITANTS IN LATIN AMERICA.

	Argentina	Bolivia	Brazil	Colombia	Costa Rica	Chile
1998	0.8	0.6	1.5	1.1	2.6	1.7
2002	11.2	2.2*	8.2	4.6	9.3*	20.1*
	Ecuador	**El Salvador**	Guatemala	Honduras	Mexico	Nicaragua
1998	0.1	0.4	0.5	0.3	1.3	0.3
2002	3.9	4.6	1.7*	3.0	4.6	1.7
	Panama	Paraguay	Peru	Uruguay	Venezuela	*Average*
1998	1.1	0.2	1.2	6.9	1.4	*1.3*
2002	4.1*	1.7	7.7*	11.9*	5.0	*6.2*

Source: ITU.
*: information for 2002 not available, year reported is 2001.

As shown in Table 11, the fixed line market is dominated by CTE, with a market share of approximately 90%. This number reflects a combination of substantial competition in the large consumer market and very little competition in the residential market.

Table 11: MARKET PARTICIPATION IN FIXED LINE MARKET AND SEGMENTS IN 2002 (%).

	Overall fixed	Large consumers*
CTE:	90	52.5
Telefónica:	3.4	39
Salnet:	2.8	n.a.
Telemóvil:	2.2	n.a.
GCA:	0.8	n.a.
Saltel:	0.5	n.a.
Others:	0.2	n.a.

SOURCE: (Fusades, 2003b).
*: corresponds to E-1 and Red Digital de Servicios Integrados (RDSI) lines.

By contrast, the number of significant participants in the mobile telephone market is larger, as suggested by Table 12. A fifth firm, (Oceanic Digital Communications) recently paid US$25.5 for 50 megahertz of the PCS frequency and is expected to begin operating soon. Similarly, the number of significant players in the international long distance market is also considerable (Table 13).

Table 12: MARKET PARTICIPATION IN MOBILE PHONE MARKET IN 2002 (%).

Telemóvil	Telefónica El Salvador	CTE Personal	Digicel
42	35	17	6

Source: (Fusades, 2003b).

Table 13: MARKET PARTICIPATION, INTERNATIONAL LONG DISTANCE, 2002 (%).

Telecom	Telefónica	Salnet	Newcom	Others
40	26	17	12	5

Source: (Fusades, 2003b).

5.2 Evaluation and Policy Recommendations

When liberalizing the telecommunications markets, countries face three major challenges. First, governments must convince potential investors that regulatory institutions will not be used to expropriate their investments and that regulatory arrangements are enforceable and politically durable (the commitment problem). Second, the government wants to prevent the incumbent from extracting monopoly profits from its customers (the price regulation problem). Third, the government wants to create market conditions that foster competition (the entry problem).

5.2.1 Local Telephony

The challenge that seems to have been considered most important when privatizing telecommunications in El Salvador, at least as far as the local telephony market is concerned, is the commitment problem. The regulatory agency (SIGET) is weak and regulations are among the most liberal in the world. Furthermore, the law considered a clause according to which monthly fees charged by the incumbent monopolist in fixed telephony would increase in line with investments made by this firm. This explains why some of the fees paid by users increased between 1998 and 2002. For example, both the monthly residential fee and national long distance calls increased by more than 20% (Table 6). User fees were linked to investments as a means of compensating the incumbent for the end of the subsidy that existed from long distance to local telephony before privatization.[30]

The regulatory framework succeeded in increasing access to fixed telephony. As mentioned above, an increase of 70% in four years is definitively a success. The main improvement to be expected from liberalizing the telephony market was a significant increase in investment and this indeed has been the case in El Salvador. The quibbles that follow should therefore be kept in the right perspective.

With hindsight, having included a clause linking investments to increases in fees was unfortunate. First, as mentioned above, the costs of local telephony increased in El Salvador (Table 6), while it was decreasing in most countries. This possibly explains part of the current malaise toward privatizations.

Second, the proviso was so generous, that the government and incumbent agreed that the increases to which the incumbent was entitled were unfeasible. The resulting agreement led to SIGET resolution T340, passed in 2002, establishing that price increases accrued to the dominant firm would be phased in over a seven year period. Such bilateral negotiations run counter to one of the principles underlying a well-functioning regulatory framework, according to which lack of discretion by the regulator (and government) are a central component. Somewhat ironically we have that an exaggerated emphasis on dealing with the commitment problem may backfire, since returns that are too high are not politically feasible.

Looking forward, the major public policy challenge faced in local telephony is to foster competition, especially in the residential market segment, since the large consumer market seems to be rather competitive.[31] As discussed below, the regulation of both physical interconnection and interconnection fees should increase competition substantially, since it will facilitate the

[30] Such subsidies were the norm under state-owned telephony.
[31] A full evaluation would require information on user fees in the latter market, such an information is not available.

entry of IP-telephony as a viable competitor in the local telephony segment.[32] In this way cable TV providers, which use IP-telephony, will be able to enter the local telephony market. Also, this should help develop the broad-band market for internet, thereby fostering competition in this market as well (there is lots of scope for increasing the number of internet subscribers, see Table 10). Yet to promote competition with the entry of IP-providers, it is important that current firms in local telephony be prevented from entering IP-telephony.[33]

5.2.2 The Interconnection Problem

An important part of the regulatory problem (related to both the price regulation and the entry problems) is to force the incumbent to provide efficient interconnection arrangements for its competitors. To achieve this goal, interconnection pricing must cope with two problems: the market power of local access carriers in termination charges and the incentive of the incumbent not to offer interconnection to entrants.

Given an entrant's need for interconnection, an incumbent has two strategies that enable it to create barriers to entry. One is to charge high prices for completing connection that make use of the entrant's facilities. The other is to provide technically inferior connection between its facilities and the facilities of a competitor. Together these strategies create the "interconnection problem" for entrants.

According to some analysts, SIGET has played an active and successful role ensuring that entrants in the mobile market are interconnected in a timely manner. Yet the regulatory agency has been less successful promoting interconnection for IP providers who may potentially participate in the local telephone market.

A workable solution of the interconnection problem begins by separating physical interconnection from the process by which interconnection fees are set. Physical interconnection can and should be subject to detailed regulation, concentrating on all technical issues involved. In case of disagreement between the incumbent and the entrant, the burden of proof should be put on the incumbent. The result of such a regulation is that an entrant is ensured physical interconnection in a pre-established period of time. Such an approach has been used successfully in Chile, not only in telecommunications but also in the electric sector. It should be a high priority to put similar regulations in place in El Salvador.

With physical interconnection out of the way, we can turn to the problem of pricing interconnection. El Salvador's Telecommunications Law considers a "jurisprudence of contracts" approach, according to which any entrant is ensured a deal at least as good as any of the existing deals between the incumbent and other market participants. In principle one may argue that as long as interconnection fees are symmetric, so that the entrant pays the incumbent the same fee it

[32] This is beginning to happen in other countries of Latin America.

[33] With a competition law in place this would be an issue for the competition agency. Under current circumstances in El Salvador, it is an issue for the regulatory agency SIGET, which is somewhat unfortunate since it puts an additional burden on the regulator.

receives for calls from the incumbent, the exact value of such a fee is not essential.[34] Yet (Laffont and Tirole, 2000) have shown that higher interconnection fees blunt competition and therefore reduce consumer welfare. This suggests that El Salvador consider regulating interconnection fees in the future, as is increasingly the case across Latin America.

5.2.3 Mobile Telephony

Growth in the number of subscribers to mobile telephony has been impressive (Table 6). Yet these growth statistics overstate the increase in benefits accruing to consumers, since the existence of a relatively high interconnection fee from fixed to mobile phones has led mobile firms to subsidize the price of cellular phones for subscribers.[35] This, in turn, means that many mobile subscribers use their cellular phones mainly to receive calls, not to make calls. A high access fee for calls from fixed to mobile phones has also led to an increasing number of fixed phones being blocked from making calls to mobile phones. The end result is that many mobile subscribers do not make calls and increasingly receive fewer and fewer incoming calls as well. Even though no hard statistics illustrating the scenario described above are available, anecdotal evidence is consistent with every point.[36] The preceding discussion suggests considering the possibility of reducing the regulated access fee from fixed to mobile phones.

As discussed in Section 5.2.1, unregulated access fees between mobile providers are likely to be too high, facilitating collusion among providers. This suggests the importance of regulating such fees. Calculations based on existing mobile subscription plans (Fusades, 2003, p. 237) suggest that mobile fees could be reduced considerably if more competition were introduced into this market.

5.2.4 Plan Puebla-Panama

As far as telecommunications are concerned, the Plan Puebla-Panama entails adapting the regulations on information and communications technologies (ICTs) in the Mesoamerican countries in order to improve conditions for private sector investment. The plan seeks to help the region in the development of ICT policies and regulations, strengthening regional institutions and cooperation among countries, and promoting dialogue between the private and public sectors. Technical assistance would be required in the following areas: (i) the strengthening of the institutional procedures and structure for formulating ICT development policies; (ii) the development of harmonized national and regional telecommunications regulation; and (iii) the development of regulations in areas such as consumer protection, intellectual property rights and security.

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[34] It should be noted that the Telecommunications Law does *not* impose symmetric fees.

[35] Especially in the pre-paid segment of mobile telephony.

[36] Similar problems have occurred and been documented in other countries in Latin America. For example, the regulator in Chile estimates that interconnection fees, which are very similar to those in El Salvador, are considerably higher than justified by long run marginal cost pricing.

One concrete benefit that is expected from the Plan Puebla-Panama is to avoid having phone calls between Mesoamerican countries pass through Miami, as is currently the case. The plan could also be a first step toward having several nations collaborate in establishing a Mesoamerican authority to regulate telephone companies in all participating countries, an option advocated by some analysts as an attractive and feasible alternative to weak local regulatory institutions (Noll, 2000).

5.2.5 Competition issues

Some policies that would foster competition in telecommunications, such as regulation of physical interconnection and interconnection fees, have already been discussed. Other policies are considered next.

First, a source of concern is the fact that the ban on mergers in the telecommunications sector included in the Telecommunications Law ends in September of 2003. This is particularly worrisome since there is no competition authority in place. An urgent measure, therefore, is that SIGET use its right to foster competition to review every possible merger in the light of its impact on competition.

Second, a simple measure that would strengthen competition is to have subscribers own the telephone number they subscribe to. In this way they can change providers while keeping their telephone numbers, thereby lowering the costs of switching providers and increasing competition. Portable telephone numbers are technically feasible at a low cost. Indeed, 800 numbers in El Salvador are portable since 2001. Extending this measure beyond 800 numbers would foster competition and benefit consumers significantly, especially in the mobile market.

Finally, the Salvadoran law does not preclude the possibility that one provider own more than one mobile telephony franchise. Again, on competition grounds, it may be desirable to limit the number of franchises one firm may hold.

5.2.6 Quality of service

According to the 2001–2002 World Economic Forum Competitiveness Report, El Salvador occupies the third place in Latin America in perception of quality and prices in telecommunications. This good result reflects the fact that the business sector is relatively satisfied with telecomms.

Residential consumers, on the other hand, are likely to be less satisfied. Basic statistics are the following: 86.3% of malfunctioning phones are repaired within one working day, congestion during peak hours leads to 9.9% of calls not being completed, and 81.6% of complaints during 2002 were solved in favor of users.

The statistics above do not fully reflect the reality encountered by residential users. For example, when a subscriber complains about a telephone bill, the operator has 45 days to reply to the complaint, which seems a rather long time period. If the user is not satisfied with the operator's response, he may ask the Consumer Protection Agency (DPC) to intervene. DPC then asks SIGET for a technical report, which often poses a major challenge for SIGET, since it cannot inspect the operator to check the veracity of the information it has provided. Even though a high fraction of complaints end up being resolved in favor of the user, the procedure in place is biased in favor of operators, providing an additional explanation for the existing discontent with privatization.

5.2.7 Taking Stock

In line with what has happened across most countries in Latin America, coverage in telecommunications has increased dramatically in recent years. This was the main promise from privatization and it has clearly delivered.

Yet more can and should be done, to increase competition in the telecommunications sector and reduce dissatisfaction with privatized telecomms among citizens. Some measures are relatively simple, others pose major political challenges and need to be evaluated carefully.

Among simple measures are the introduction of portable numbers and the implementation of a much faster process to deal with user complaints. More challenging measures include regulating physical interconnection and interconnection fees, and avoiding mergers that are detrimental to competition.

6. Conclusion

Market reforms should benefit everyone, which requires that the efficiency gains that come with reforms are passed on to consumers. Otherwise reforms will fail to attract the political support needed for them to prevail.

This chapter has suggested policies that can go a long way toward having market reforms benefit everybody. Some policy recommendations should be easy to put in place, others may pose some non-trivial technical and political challenges.

Common across the four topics considered – competition policy, consumer protection, electricity and telecommunications - is the need for more active regulators. Even though, on a comparative basis, the proposed roles for regulators are still quite modest, the important issue of insulating the regulator and holding him accountable is important and should be considered.

A list with the most important policies follows.

6.1 Competition Policy

The absence of a competition law in El Salvador is inconsistent with a well functioning market economy. A modern competition law should be passed. It should center on conduct, not structure, and should include an advocacy role for the competition authority. Also, further tariff reductions, especially for consumer goods, should be considered to foster competition in consumer markets.

6.2 Consumer Protection

Consumer protection policies need to be strengthened. In particular, the Consumer Protection Law should be revised so that violations lead to pecuniary penalties (and not admonitions, as is currently the case). And the Consumer Protection Agency's budget should be increased significantly, among other reasons to increase national coverage.

6.3 Electricity

Since reforms were recently approved for this sector, a wait-and-see attitude is recommended. In the meantime, the regulator (SIGET) should conduct (and publish) studies analyzing market power in different segments of this sector, since there are well grounded concerns that some market participants, both in generation and distribution, may exert market power.

6.4 Telecommunications

Some simple policies include portability of phone numbers and faster procedures to deal with consumer complaints. More ambitious reforms, which require careful evaluation, include regulating physical interconnection, regulating interconnection fees and forbidding mergers that are detrimental to competition. The latter is particularly urgent, since the ban on mergers included in the Telecommunications Law expired in September of 2003.

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