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## Regulation of Latin American's Information & Communications Technology (ICT) Sector: An empirical analysis

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# **Regulation of Latin American's Information & Communications Technology (ICT) Sector: An Empirical Analysis**

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## **Abstract**

In the mid-1980s a movement towards privatization and de-regulation of the telecommunications sector was begun. The sector has been privatized in most countries and subjected to regulatory reform. The major reform occurred in the late 1990s. Since then the internet and cellular-mobile industries have advanced significantly. Mobile service has exploded, particularly in the developing world. This has changed the dynamics of the industry dramatically.

This paper empirically evaluates the reforms twenty-plus years after they have been implemented in selected Latin American countries using cross-country analysis. Earlier studies did not account for the regulatory environment nor cover the entire ICT sector. This paper empirically evaluates the impact of regulation in selected Latin American countries. The results are only suggestive, but not conclusive – that weaker regulation supports investment in the ICT sector due to higher prices for the service.

**Keywords:** Information & communications technology (ICT), economic growth, investment, mobile phones, privatization, regulation, regulatory reform.

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## 1. Overview/Introduction

Thirty years ago, virtually the entire telecommunications sector was state owned, managed and controlled. Government intervention was usually justified on the basis of monopoly/oligopoly power – a market failure. Without state intervention prices would be too high, demand would be restricted and excess profits (beyond the normal return on investment) would be obtained, which creates inefficiencies and leads to high social costs and loss of welfare. Because of the large fixed cost of provision of the services, it was felt a monopoly could provide the services at the lowest possible cost. The sector was perceived as a public utility. More recently, network externalities have been suggested as a rationale for intervention in this sector – that is the more people connected to the network, the more valuable it will be. Its public value is greater than its private value. Thus virtually all of the telecommunications systems have been owned, managed and controlled by the state since their inception.<sup>2</sup>

However, in the mid-1980s a movement towards privatization, liberalization and deregulation took hold, pushed by President *Reagan's administration* in the United States and Prime Minister Thatcher's *administration* in the United Kingdom. Now the sector has been privatized in most countries and subjected to regulatory reform of one sort or another: liberalization, competition or “light-handed” regulation. The major reform occurred in the late 1990s (Estache *et al.* 2006). Since then the Internet and cellular-mobile industries have advanced significantly. Mobile service<sup>3</sup> has exploded, particularly, in the developing world. This has changed the dynamics of the industry dramatically.<sup>4</sup>

The paper updates and expands the work on the efficacy of regulation using cross-country analysis of selected Latin American countries. It follows the frameworks of Röller and Waverman (2001); and Waverman *et al.* (2005); and Czernich *et al.* (2009). It is in the spirit of Estache *et al.* (2006) in that it examines outcomes after privatization and regulatory reform. It examines the metrics of success (or failure): increased penetration of the mobile telephone

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<sup>2</sup> The exceptions were the United States and Canada where the inventor of the telephone started companies and some Scandinavian systems.

<sup>3</sup> Cellular-mobile, cellular and mobile are used interchangeable in this paper.

<sup>4</sup> The sector is now referred to as information and communications technology (ICT) to address its expanded scope.

service. Related to these metrics is the requirement that investment incentives are maintained or enhanced.

The paper is organized as follows: A Literature Review following this Introduction/Overview. It reviews the economic literature on ICT's impact on economic growth and development and the research on the effectiveness of regulation. The third section describes the countries under review: their descriptive statistics. The fourth section describes the methodology and the sources of the data; the results are in the fifth section. The final section presents Conclusions and Recommendations

## **2. Literature review**

A variety of papers review the economic literature on ICT's contribution to growth and development – including Internet, broadband, mobile services as well as fixed line service – regulation, regulatory governance, and Latin America ICT environment. Thus, we indicate where these reviews may be found and update the material as appropriate.

### *Growth*

The determinants of economic growth have been a concern of researchers since the beginning of the discipline. It is only relatively recently, beginning in the early 1980's, that the contribution of the ICT sector has been a concern.<sup>5</sup> Earlier research by Alleman *et al.* (1991) addresses the research on telephony's impact on economic growth and development and has a comprehensive literature review of the work up to 1991. Koutroumpis (2009, pp. 2-4) has a review of the literature on the determinants of economic growth in general, as well as telephony and broadband networks in particular. Vu (2011, pp. 354-355) has a brief review of the ICT cross-country studies as well as the national studies.

Early work on ICT's contribution to growth was relatively modest in its approach, using simple regression models of GDP growth against telephone penetration (in logarithmic

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<sup>5</sup> Solow (1987) famously stated that “You can see the computer age everywhere but in the productivity statistics”; this became known as Solow's Paradox (Brynjolfsson 1993). The ICT literature addressed this “Paradox.”

transformations) or similar variables. The more recent work has attempted to account for endogeneity and to determine the magnitude and direction of causality. Two strategies have emerged to address this – the use of instrumental variables (Czernich *et al.* 2009) and the use of a structural model of the sector (Röller and Waverman 2001). Röller and Waverman's (2001) seminal work constructed a micro supply and demand model before addressing the macroeconomic impacts. They provide a strong critique of the earlier models. The variance in others' results could be clarified by their approach. Others followed in their footsteps: Koutroumpis (2009); and Waverman *et al.* (2005).

Koutroumpis (2009) estimates the impact of broadband on the infrastructure and growth for 15 European countries over the period 2003 to 2005. He finds a significant positive causal impact, particularly when the infrastructure has a critical mass. Similarly Waverman *et al.* (2005) estimated the impact of mobile telephone service on growth. They found it contributed significantly in low income countries; indeed, it may be twice as large in developing countries as in developed.

Katz and his coauthors (2009a, b, c; Katz, *et al.* 2009, and Katz and Suter 2009) have done a number of studies on the economic impact of ICT in Latin America and elsewhere. The global, national and regional studies of the economic impact of ICT are reviewed in Katz (2009).

More recently, Vu (2011) showed that the marginal effect on growth of the penetration of Internet users was larger than that of cellular phones, which was larger than that of personal computers for the average country.

Jung (2014) does a review of the literature of ICT's infrastructures impact on economic growth. While his focus is on broadband, he does a comprehensive review of ways in which ICT can enhance economic activities as suggested by the literature. Thus, they will not be discussed here.

These studies, generally, do not account for the regulatory environment and, in most cases, do not cover the entire ICT sector. This is the contribution of this paper.

### *Public policy & regulation*

Two strands of the literature on economics of regulation are theoretical or empirical, with a few exceptions (see Krämer *et al.* 2014). This review will focus on empirical approaches in terms of efficacy of regulatory reform and quality of the regulation.

Cambini and Jiang (2009) have a comprehensive review of the literature of regulation and broadband investment up to the late 2000s. They note that the conflict between competition, regulation and investment has been addressed in both the theoretical and empirical literature, which they review. They found that the impact of regulation on investments is not conclusive; more research is needed.

### *Efficacy of reforms*

As noted, the evolution of the ICT sector was perceived as a public utility and hence, it has been owned and controlled by the state or subject to regulation, licensing, and a variety of other public policy controls. But this changed in the mid-1980s with privatizations and regulatory reform. This process is virtually complete, and is even being reversed in some cases.

Since then the Internet has developed and the cellular-mobile industry has exploded, particularly in the developing world. This has changed the dynamics of the industry dramatically. The success of regulatory policy in Latin America is the focus of this paper.

The economics literature on the reform of the telecommunications sector is extensive. It is one of the most analyzed of all of the basic infrastructures. Some are an evaluation of general reform; most are country specific studies with significantly fewer cross-country studies. A detailed review of the cross-country studies is contained in Estache *et al.* (2006).

However, many of the studies of the efficacy of the telecommunications reform policies were completed before the growth of mobile and Internet services. They concentrated on fixed line growth and did not address wireless or broadband services. Other strands of the ICT regulatory literature examine quality (e.g. Ai *et al.* 2004) such as price, etc.

### *Quality of the regulation*

The degree to which regulation is independent of the government is another metric that has been analyzed in the economics literature. In general it is assumed and supported by empirical research that the more independent the regulator is from government, the “better”

the regulation will be. The matrix of performance indicators are; quality of service, access charges, affordability, fiscal costs and productivity (Estache *et al.* 2006). The “independence” of the Independent Regulatory Agencies (IRA) is important in performance, but also private capital makes an important contribution.

...the basic data analysis tells us that countries with private capital and an IRA have, on average, more subscribers, lower prices of local calls, lower fixed costs, lower faults, and higher labor productivity (Estache *et al.* 2006, p. 7).

But developed and developing countries exhibit considerable differences. Estache *et al.* (2006) review in detail the cross-country studies as a prelude to their own study. Their study adds country political risk, including corruption, which will have an impact on private investment in the infrastructure.

#### *Access pricing & regulation*

Regulatory authorities set the framework to determine access pricing. The impact of these frameworks has been researched in the industry. Contention exists among what framework is appropriate from an economic perspective. Since the bulk of the regulators, at least in Europe, have chosen some form of long run incremental cost (LRIC), and most of the balance of the countries has selected full allocated/distributed costs (FDC) (Nitsche and Wiethaus 2011)<sup>6</sup>, the economic literature has examined these questions in this context. One of the most recent studies, Nitsche and Wiethaus (2011), examines different types of access pricing approaches and how they affect investments and consumer welfare. They find a FDC approach

... or a regulatory holiday induces highest investments, followed by risk-sharing and LRIC regulation. Simulations indicate that risk-sharing creates most consumer welfare, followed by regimes with fully distributed costs, regulatory holiday and long run incremental costs, respectively. Risk-sharing benefits consumers as it combines relatively high *ex-ante* investment incentives with strong *ex-post* competitive intensity.” (Nitsche and Wiethaus 2011, p. 263)

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<sup>6</sup> The authors, and others, have found difficulties with these methodologies because they are static, and do not reflect the realities of market behavior; however these methods are what are used in practice. See Alleman and Rappoport (2005) and Pindyck (2004) and the reference cited therein.



### *Summary*

The ICT sector has been researched extensively, but much remains to be done: The confluence of increased means of communications, privatization, regulatory reform, lower prices/costs, and rising income levels have made it difficult to determine the direction of causality and impact of various policy changes. But this is critical; when countries such as Australia invest billions of dollars to create a broadband infrastructure (Eisenach 2014), it is critical. We hope this research will make a small contribution to this understanding.

### **3. Latin America's ICT environment**

Below the ICT environments of Latin America are illustrated. For clarity the countries of South America and Central America/Mexico<sup>7</sup> are displayed separately. The Caribbean countries are excluded from this review because of their size and uniqueness. The South America countries included are: Argentina, Belize, Bolivia, Brazil, Chile, Colombia, Ecuador, Guyana, Paraguay, Peru, Suriname, Uruguay and Venezuela. French Guiana is excluded because its data is combined with France's statistics. The Central America and Mexico countries are: Costa Rica, El Salvador, Guatemala, Honduras, Mexico, and Nicaragua, and Panama. The International Telecommunication Union is the source of the data used below.<sup>8</sup> Ultimately Belize, Guyana, and Suriname were dropped in the modelling due to data limitations.

The traditional fixed-line telephone service has not grown nearly as fast as the mobile service. Indeed, the mobile service is a substitute for it, although the fixed-line does offer the opportunity to provide an Internet or even broadband internet services. Even in developing countries, individuals are "cutting-the-cords" – that is giving up their fixed-line in favor of cellular service (Banerjee *et al.* 2014).

#### *Cellular-Mobile service*

Figure 1 and Figure 2 clearly show that the growth of cellular telephone service has been spectacular. The average compound annual growth rates (CAGR) for the South American countries is over twenty percent (21.26 %) since 2000. Virtually all South American

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<sup>7</sup> Mexico is classified as North America, but we include it as part of Latin America.

<sup>8</sup> We would like to thank Carlos Sánchez of IBEI for help in obtaining the access to the databases.

countries have 100 percent or better penetration. Several, much better: Argentina, Brazil Chile, and Uruguay have over 1.2 cellular phones for every inhabitant.<sup>9</sup>

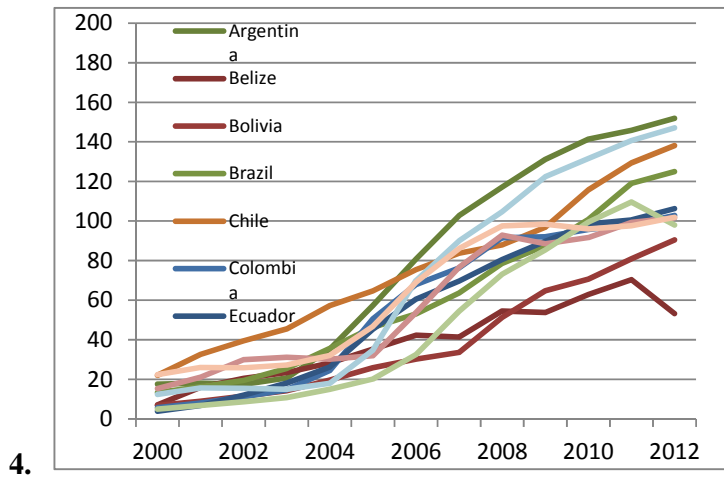


Figure 1 Mobiles per 100 inhabitants, South America

Similarly, Central America and Mexico (see Figure 2) have also seen spectacular growth in wireless. The average compound annual growth rates (CAGR) for these countries is nearly thirty percent (27.97 %) since 2000.

Panama has the lead in Central America with 1.8 wireless phones for every one inhabitant. But most of the others are above or near one mobile per person. Honduras, Mexico and Nicaragua are the stragglers: they have slightly under 100 mobile phones per 100 inhabitants (83, 93, and 86, respectively).

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<sup>9</sup> One has to be careful with these data since mobile phones are counted by the number of SIM cards, but many people will have only one phone and multiple SIM cards to take advantage of the rates of alternative carriers.

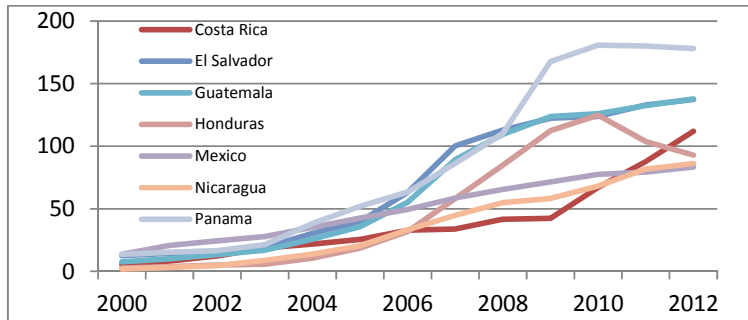


Figure 2 Mobiles per 100 inhabitants, Central America & Mexico

*Internet service*

While the pattern for internet penetration is not as dramatic as wireless-mobile service, it has made significant progress over the last dozen years of growth. For South America – Chile, Uruguay and Argentina are above fifty percent of individuals with access to the Internet; many Central American countries are doing nearly as well. Figure 3 shows the growth of Internet per 100 inhabitants for South America and Figure 4 for Central America and Mexico.

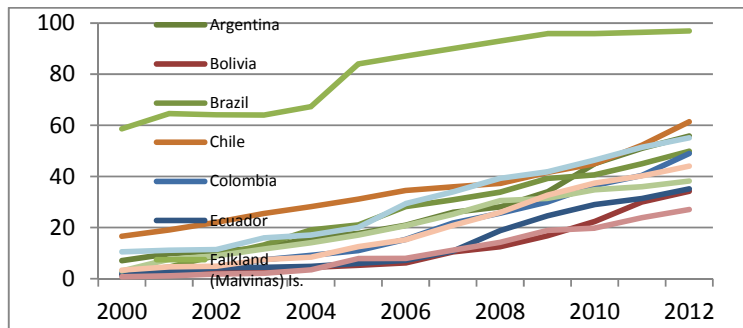


Figure 3 Internet per 100 inhabitants, South America

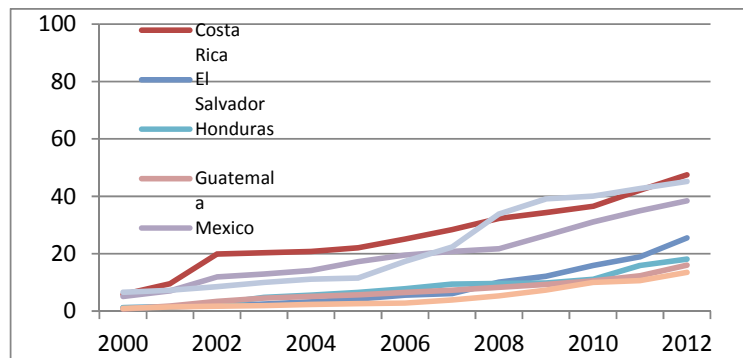


Figure 4: Internet per 100 inhabitants, Central America & Mexico

The laggards in South America are Paraguay and Belize, not yet reaching thirty percent (30%) penetration. Similarly, for Central America, El Salvador has not yet reached thirty percent (30%), Nicaragua and Honduras are even farther behind; they have not yet reached twenty percent (20%).

#### *Fixed-Line telephone service*

The pattern is very different for fixed-line telephone service. The penetration rates have decreased over time in many countries. This is due, no doubt, to the substitution of mobile for the fixed-line phone. These networks were not well developed and had low penetration, in part, due to the fact that they were not ubiquitous.

Figure 5 shows how slow the growth of fixed line service has been; indeed, it has been negative for many countries of South America. The CAGR for these countries is less than

one and a half percent (1.43 %) since 2000. Penetration rates are less than thirty percent and most are under twenty percent.<sup>10</sup>

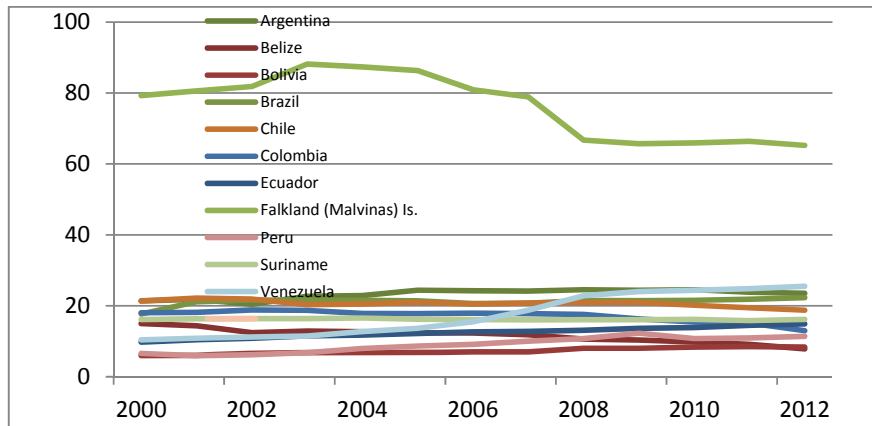


Figure 5 Fixed-lines per 100 inhabitants, South America

A similar pattern is exhibited for Central America and Mexico. Figure 6 shows how slow the growth of fixed-line service has been for Central America and Mexico. The CAGR for these countries is just over three percent (3.06 %) since 2000 and under twenty percent penetration, some significantly under this.

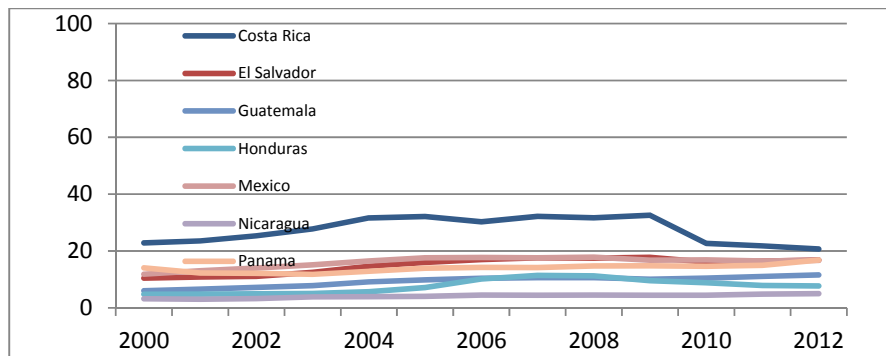


Figure 6 Fixed-lines per 100 inhabitants, Central America & Mexico

### Summary

Progress has been made in new ICT services in these regions; less so with the traditional telephone service. The question remains: Was the progress due to technical change,

<sup>10</sup> Falkland (Malvinas) Islands is the exception with 65 % penetration.

privatization, competition, regulatory reform and/or liberalization or yet some other factor(s)?  
Could it have been better?

## 5. Methodology

The impact of ICT regulation on economic growth in selected Latin American Countries is examined following the *Waverman et al.* (2005) approach: an Annual Production Function (APF). This was based on the earlier work of Röller and Waverman (R-W) (2001). In addition an Endogenous Technical Change (ETC) model was explored based on Robert Barro's (1991) approach. In this framework the volatility of the economy during the period under study had to be taken into account. Data from selected countries of South and Central America and Mexico are used. As noted in the literature review, others have shown that ICT, most recently cellular mobile phone and broadband services, have an impact on economic growth as did fixed-line service in an earlier period. The question addressed in this paper is what is the impact of regulation?

As indicated earlier Internet and, particularly, mobile telephone services have grown spectacularly in the last decade. Privatizations have had time to settle and regulation has had time to mature. Thus, it is appropriate to examine their combined impact.

### *Data*

The data set was obtained from several sources. The ICT data was gathered from the International Telecommunication Union's (ITU) World Telecommunications Indicators database. It is a rich source of ICT data and includes breakdowns of fixed, mobile, Internet subscribers, revenues, and other ICT data. It is updated annually (ITU 2014). This is the main foundation of the data set. The World Bank's World Development Indicators (WDI) database is used for basic data such as population, GDP, and total labor force. The capital stock comes from the work of Berlemann and Wesselhöft (2012) who estimated aggregate capital stocks using the perpetual inventory method.<sup>11</sup> International Monetary Fund (IMF), World Economic Outlook Database (2014) is the principal source for the endogenous technical change estimation. Broadband prices are courtesy of Hernán Galperin as used in his paper (2013). The "strength" of regulation data is from the World Economic Forum *Global*

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<sup>11</sup> Available at [http://www.hsu-hh.de/download-1.5.1.php?brick\\_id=552HQnG7mehYINnS](http://www.hsu-hh.de/download-1.5.1.php?brick_id=552HQnG7mehYINnS) [1.05.2014]

*Competitiveness Report.* Gaps in the data left eight countries for the estimations with time period going from 2007 – 2011 with which to work. They are Argentina, Bolivia, Brazil, Ecuador, Peru, Venezuela, Costa Rica and Mexico. Because of data limitations in the remaining countries, various estimations are dropped for some years and some countries.

*Estimation/results*

*Annual production function*

A three-equation modification of the Rölller-Waverman approach is used in the estimation of the Annual Production Function model. The summary of the results are shown in Tables 1 to 3. The details are in the Appendix.

The first equation, Output, estimates the level of output (GDP) as a function of the total physical capital stock net of ICT capital, the total labor force, and the mobile penetration rate. All of the variables are in natural logarithms hence the coefficients can be interpreted as elasticities. The sum of the coefficients of the capital stock and labor force are approximately one (0.954), indicating a slight decline in returns to scale, but consistent with constant returns-to-scale.

Table 1 Output equation (the natural log of real GDP in constant 2005 \$US)

Variable	Coefficients	t-Statistic
Capital	0.287	2.924
Labor	0.667	4.403
Mobile Penetration	0.064	4.778

The Output Model’s sum of capital and labor coefficients is ~ 0.95 – consistent with the literature – and constant returns-to-scale. Mobile penetration has a small, but positive impact – a ten percent increase in mobile penetration contributes 0.6 percent to GDP growth. All of the variables are significant.

The second equation, Demand, estimates the level of mobile telecoms penetration as a function of GDP per capita, the price of mobile service (calculated from mobile revenue per

mobile subscriber), internet penetration, the fixed-line price (which is fixed-line revenue per fixed-line subscriber) and education expenses as a percent of Gross National Income (GNI).

Table 2: Demand estimation (the natural log of mobiles per 100)

Variable	Coefficients	t-Statistic
Mobile Price	-0.405	-3.674
GDP per Capita	3.584	9.744
Education	0.836	3.769
Internet Penetration	0.383	4.549
Telephone Prices	0.058	0.755

The Demand Model's own price elasticity is  $-0.405^{12}$ ; education expenditures impacts demand – ten percent increase in education expenditure will increase demand by 8.4 percent; income elasticity is high at 3.584, but this may be due to trends. Internet penetration influences demand as well; it has a synergy with cellular services – for every increase in internet penetration, this will lead to nearly a four percent (3.8%) increase in the demand for mobile service. All of these coefficients are significant. The cross-price elasticity with fixed telephony is 0.058, but not significant.

The last equation, "Investment" is the change in mobile penetration each year as a function of mobile prices, regulation and telephone prices. The first two variables are of the correct sign - the increase in mobile prices will induce more investment – and the weaker the regulation (the higher the value and the less regulatory burden) the more incentive to invest. However, these variables only border on significance. The telephone price coefficient, as in the other equations, is not significant. Give the low level of penetration in these countries, this is not surprising.

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<sup>12</sup> As mobile becomes more important over time one would expect the price elasticity to fall.



Table 3: “Investment” Equation (the natural log of the difference of mobiles per 100)

Variable	Coefficients	t-Statistic
Mobile Price	0.432	1.238
Regulation	0.845	1.380
Telephone Price	-0.029	-0.168

The positive mobile price coefficient of 0.432 indicates that the higher price for mobile services, the more will be invested in this area. The regulation coefficient is positive and is almost significant at the 10% level. This positive coefficient on regulation is expected (the higher the value, the less regulatory burden).

Other estimation methods were investigated – instrumental variables and simultaneous equation methods, but they did not improve the estimates. Appealing to Occam’s razor, the simpler model was used.

*Endogenous technical change*

The growth equation approach of Barro (1991) is used in the estimation of the Endogenous Technical Change (ETC) model. The summary of the results are shown in Table 4. The details are in the Appendix.

The volatility of the economy during the period under study is reflected in the importance of the percentage changes in imports, the percent of borrowing, and real GDP in purchasing power parity (PPP) in 2005 dollars. Percentage change in exports are also important. All of the other coefficients are significant at the 0.01 level or better except for the change in mobile penetration.

The ETC model is not sensitive to changes in mobile penetration. The other variables in the model overpower any effect that the former has. More research is required in this area.

Table 4: Annual Rate of GDP Growth

Variable	Coefficients	t-Statistic
Percentage change in Imports	0.0013	6.299
Change in Telephone Penetration	0.0071	2.473
Percentage change in Exports	0.0013	2.059
Borrowing as a percent of GDP	0.0028	2.463
Real GDP in Purchasing Power Parity, 2005	.0000	2.427
Change in Mobile Penetration	0.0002	0.501

## 6. Conclusion

This paper attempts to empirically evaluate the impact of regulation in selected Latin American countries. The results are only suggestive, but not conclusive – that weaker regulation supports investment in the ICT sector due to higher prices for the service.

With the limitations on the data, we have not been able to address some of the other significant issues. What has been the impact of the reforms twenty-plus years after they have been implemented? Were privatizations a success? Were regulatory instruments adequate for social control of the industry? What most comports with competitive practices? What will be their impact on consumer, entry, and investment? Overall, what lessons can be learned from the last two decades? These questions remain for future research.

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