

Reforms and Democracy

Political Restrictions to the Implementation of Reforms

Mauricio Olivera¹
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Introduction

The wave of economic reforms in Latin America that began at the end of the 80s aimed at achieving macroeconomic stability after a decade of hyperinflation and deficits, and at setting the economies on a steady path to growth. The expanding literature on the political economy of the reforms has studied their causes (Rodrik, 1996; Drazen and Grilli, 1993), and their effects on different economic variables;² it has also constructed theoretical models to explain the ways in which the reforms were undertaken under different political circumstances, especially in economies in transition and developing countries³. However, comprehensive empirical studies of the political economy of reforms that would give clues of the way the process was done have not been developed in great detail.⁴

The purpose of this paper is to contribute to the body of empirical literature of the “Washington Consensus”⁵ reforms of the end of the 1980s and the beginning of the 1990s

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² Effects on wage differentials and employment, (Birdsall, et al, 2000), volatility (Gavin, 1997) and growth (Lora, 2001 and Fernández-Arias and Montiel, 1997) are studied in the literature.

³ See Fernández and Rodrik (1991), Alesina and Drazen (1991), Edwards (1989), Murrell (1989), Wei (1997), Dewatripont and Roland (1992a, 1992b, and 1995), and Tommasi and Velasco (1996).

⁴ For Latin America, two papers (Lora 1997, and Graham, et al, 1999) attempt to explain empirically the political economy of the reforms.

⁵ A term coined by Williamson (1990), and called the new paradigm for development by Gore (2000).

in Latin America. Specifically, it will examine which political factors affected their implementation, and the strategies that the reformers used to surpass the political restrictions. It will also study the democratic framework consisting of different institutional arrangements and political structures under which the reforms were undertaken. In presidential democracies, coordination of negotiations between the executive power and the legislature is vital for the implementation of reforms. Each party with seats in the congress represents different groups with diverse interests. In order to obtain the best portion of the reforms for their constituencies, the parties and candidates use bargaining tactics and strategies that are organized through the political structure, which includes constitutional powers conceded to the president, features of the party system and the internal organization of parties. The paper will contribute to the new literature that seeks to identify micro-institutions as factors that explain the political economy of reforms studying and assessing the political structure. Additionally, it is an empirical attempt to understand how the process of negotiation took place, and to evaluate the way the reforms were marketed in Latin America.

The paper is organized as follows: to introduce the economic and democratic environments where the reforms were undertaken, the subsequent section describes in a summarized way economic and political Latin American history since the 1980s. In order to model the democratic environment, the third section reviews different theoretical approaches to the political economy of reforms. It also describes different strategies to market the reforms in different democratic environments. At the end of the section, in order to identify and underline the forces that drive negotiations in the congress, political

restrictions, and the strategies that the executive could follow to surpass them, an example is organized using a game theory model. In the fourth part, the empirical exercise is presented: the hypotheses are reexamined, the data used is described, and the results reported. Finally, some conclusions are extracted in the fifth part.

How Did Reforms Arrive in Latin America? A Short Historical Review

Latin America experienced its biggest wave of democratization (called by Huntington “The Third Wave”⁶) during the last century in the first half of the 1980s (Mainwaring, 1999). In 1978 only three countries – Colombia, Costa Rica, and Venezuela – could be considered democracies. The rest of the countries were suffering under dictatorships and military governments. In Figure 1, the Freedom House index⁷ of democracy by region shows the biggest increase for Latin America in the beginning of the 1980s. Although in comparison with long-established democracies in industrialized countries Latin America’s democratization process has not reached its potential, significant strides have been made in the region over the last three decades (Mainwaring, 1999; IDB, 2000).

<<Insert Figure 1>>

Almost all Latin American countries adopted presidential system for their basic democratic political structure, except some of the English speakers (Trinidad and Tobago and Jamaica), which adopted parliamentary systems. To be chosen as a system of government, parliamentary failed to gain enough support among elites and the broader

⁶ See Huntington, 1991.

population in Latin America. After the Third Wave, some countries proposed the possibility to pass to a parliamentary system, but it was defeated (Brazil in 1987-88, Argentina in the period 1983-89, and Bolivia in 1993).

At the same time, the decade of the 1980s in Latin America is known as the “lost decade” in economic terms. The second oil shock in 1979, the over-indebtedness promoted by the petrodollars, and the sharp increase of US interests rates led to the debt crisis that translated into very slow economic growth during that decade (see Table 1), accompanied by macroeconomic instability and hyperinflation (Krueger, 1993).

<<Insert Table 1>>

As the import-substitution initiatives under a closed economy model collapsed, the ensuing recession spawned a new set of questions about development for economists and political scientists. At the end of 1980s, around 100 developing countries undertook reform programs supported by the IMF and the World Bank (see Krueger, 1993 for a detailed description). The package of stabilization programs undertaken, combined with structural reforms in the areas of trade, tax, labor, finance and privatization, was designed with the following goals: a) inflation control and fiscal deficit reduction as means for macroeconomic stability; b) trade and capital account liberalization to open the economies to the rest of the world, pursuing efficiency through competence; and c) privatization and deregulation to liberalize domestic product and factor markets. In

⁷ In the index, 1 indicates the greatest degree of democracy.

general, the Washington Consensus reforms aimed to use competition to promote macroeconomic stability and sustainable growth, while boosting at the same time living standards (Krueger, 2000).

Figure 2 presents a set of structural reforms indexes in Latin America since the middle of the 1980s. The indexes measure the legislative and policy changes in five areas of reforms: trade, finance, privatization, tax, and labor. The range is between 0 and 1, where 1 represents the highest level of reform. The indexes are calculated comparing the level of reforms of each country with the remaining ones for the period 1985-1999.⁸ The figure shows the evolution of the region for the overall index of reforms and each of its components between 1985 and 1999. The total index, which includes the five types of reforms, grew from 0.34 to 0.58 for the region during the whole period. Labor reform has the most stable index, followed by post-1994 tax reforms.⁹ Financial and trade reform indexes have the highest growth rates, followed by privatization since the beginning of the 1990s.

<<Insert Figure 2>>

The path of each type of reform is then not similar. The area of trade underwent the greatest advancement, with progress of almost 80 percent compared with its initial level. Trade was followed by financial liberalization (58 percent of progress). Privatizations and

⁸ For a description of the indexes and the methodology, see Appendix 1, extracted from Lora (2001).

⁹ This is consistent with Krueger (2000). Labor and tax reforms are considered “second generation” reforms, technically and politically more complex to implement.

taxes indexes progress is between 20 and 25 percent, although with different timing. Finally, the least amount of progress was made in the area of labor code reform (2 percent, see Figure 3).

<<Insert Figure 3>>

Additionally, progress of reforms was not even across countries. Some countries reformed more than others during the period. For Bolivia, Peru and Brazil, the total index of reforms grew by more than a hundred percent of its initial level. For Uruguay and Trinidad and Tobago, the increase in the index was just 30 and 20 percent of its initial level (see Figure 4).

<<Insert Figure 4>>

As a first approximation of how reforms were undertaken, a measure of the progress of reforms relative to the median for the region is calculated. This measure helped to divide the countries in three categories: the fast reformers (BA), the slow ones (AB and BB), and the early ones (AA) (see Figure 5 and Table 2). The fast reformers began their process below the average of the region in 1985, and ended up with a higher than the median reform index in 1999. The index of the early reformers evolved above the region average for the whole period, while for the slow reformers the index is below the average.

<<Insert Figure 5>>

<<Insert Table 2>>

In summary, two historical events converged in Latin America at the end of last century. On one hand, the consolidation of democracy and presidential systems of government gave rise to new institutional arrangements. On the other hand, the development model of import substitutions collapsed, and a subsequent wave of economic reforms emerged, based on a new paradigm of open economies and competitiveness.

Political Economy of Reforms: Theory

The collapse of the import substitution model led the region to think about new ways to reach development and growth. At the end of the 1980s “Washington consensus” reforms were the answer. Why and how these reforms were adopted in a region with new democratic institutions and political systems? How did the executive and legislative powers negotiate the implementation of the reforms, and which were the strategies they used to bargain in a check and balances environment? This section extracts from the political economy literature the framework to model political institutions. Secondly, it reviews the different hypotheses about the strategies used by the reformers. In the last part, a game-theory model helps to model the political environment. The game is also useful to understand the key variables that drive negotiations in the congress, and to derive the hypothesis to be tested empirically.

Latin America stylized facts described above suggest that the deep crisis during the “lost decade” was the principal cause of the reforms (Rodrik, 1996). Although the closed

economy import-substitution model generated distortions in the economies, they were not severe enough to stimulate potentially painful and politically costly reforms. Distortions might diminish welfare and generate a dynamic deterioration (Tornell, 1998) but it is only this deterioration –or a crisis- that eventually provides enough of an incentive to make undergoing reforms seem worthwhile (Drazen and Grilli, 1993). Policies that are politically costly and unacceptable during distorted -but stable- times become tolerable when the crisis is rapidly deteriorating welfare. A classic example is the relative difficulty of gaining support to implement reforms that stop moderate inflation vs. hyperinflation.

However, why during crises some governments fail to adopt policies that are efficiency-enhancing and could re-orient the economy onto a sustainable growth path? Why is there a delay during which the situation deteriorates for some time before reforms are implemented? Why some governments cannot follow the optimal path of reforms? To explore alternative answers, in the following paragraphs two different approaches of the political economy literature of reforms will be described: the interest group and the institutional approaches¹⁰.

Interest Group Approach

The key assumption of this approach is the heterogeneity of the population, distributed among different interest groups with different political preferences. Furthermore, preferences are not static; they can shift during periods of economic deterioration. The

¹⁰ For a comprehensive survey, see Haggard (2000). Tommasi and Velasco (1996) developed a third approach, based on incomplete information that is updated during crisis and eventually generates the change of the status quo into a new economic model.

seminal paper embodying this approach is written by Alesina and Drazen (1991). . In their model, a dynamic game of incomplete information explains the politico-economic determinants of delays in the adoption of reforms. Two heterogeneous groups in the economy, aware of the necessity of a reform, must sign an agreement to implement it. Nevertheless, reforms are not implemented immediately but after some delay.

To describe the delay, think about an economy needing a reform (say, a tax reform) to narrow the fiscal deficit generated by lower-than-expected income during a strong recession. There is incomplete information about preferences, and uncertainty about which group is going to carry the higher burden of the new taxes. Therefore, the best strategy is to wait (or delay the reform) until the other group concedes. The group that first reveals its preferences is the one that will receive the higher tax burden. What are the determinants of concession? Costs and benefits balance and political preferences of each group change along with economic deterioration, and each one reacts weighting costs and gains of delaying the reforms. This “War of Attrition” model explains the delay of reforms.

Different authors have made variations on this seminal model to better explain the political economy of reforms. Other assumptions that appear in the literature are asymmetric or incomplete information about the outcome of the reforms. For Fernandez and Rodrik (1991), uncertainty about the outcome of the reform generates a bias towards the status quo. For some reforms, ex-post winners and losers cannot be identified beforehand. As a result, even ex-ante winners would delay the reforms and vote for the

status quo. Institutional arrangements could make it possible for a specific reform to identify losers, but the group of winners (although it might be larger) could be so diffuse that it is not able to organize to support the reform. For Tornell (1998), powerful groups with “common access” to the economy’s resources have incentives to over-appropriate, especially in developing countries, where law enforcement institutions are weaker. Their actions lead to economic deterioration. When this deterioration becomes a crisis, a conflict among groups arises and as a result a reform is undertaken initiated by power-holding groups in order to limit power of their political opponents. It is worth to note that in comparison to the other models for Tornell (1998) the crisis is endogenous rather than coming from external shocks¹¹. These hypotheses are also consistent with Schamis (1999) in the sense that the elite of Latin American countries built a strong coalition of winners during the import substitution deterioration. This was a time consuming process, although the reforms were presented and implemented bundled.

An alternative approach in the literature is related to credibility of reforms, which may arise under three different scenarios. On one hand, government’s reforms may be inconsistent with other policies being pursued simultaneously. Credibility test falls short since budget constraints and accounting identities are violated. On the other hand, time-inconsistency problems arise whenever incentives to renege exist. Ex-post policies are different from the ex-ante ones, and the population can identify it. Finally, and more related to the models described so far, when there is incomplete information about the reforms, in order to gain credibility the government must “signal” its true type and some

¹¹ See also Acuña and Tommasi (2000) for this type of crisis.

times overboard since the private sector cannot distinguish its policies from the ones of any other type of government. This situation occurs generally in developing countries and in countries with political instability (Rodrik, 1989).

In sum, this approach based on the heterogeneity of the population implies that the delay in implementing reforms will be shorter if coalitions can be formed. Coordination among different interest groups, credible signals, less uncertainty about the outcome of the reforms, and clear institutional arrangements for negotiations that distribute their benefits and costs would reduce the intensity of the tensions among heterogeneous groups, and eventually generate better and more efficient implementation of the reforms. Solutions of these models center on coalition-building strategies.

Institutional Approach

Heterogeneity exists in a variety of situations. Economic heterogeneity can arise between exporters and importers during the implementation of a trade reform, or when the advantages of different exchange rate regimes are discussed. Ideological heterogeneity is present in the debate of income distribution between workers and capitalists. In this section the restrictions that heterogeneity involve are modeled through political institutions, where parties are the main institutions that structure the political process. This approach studies the effects of constitutional and political rules under which political parties; politicians, and elected candidates negotiate, build coalitions, and obtain gains from policies. It also identifies the incentives that determine the behavior of politicians. Political institutions can be classified into three groups: nature of the party

system, internal organization of parties, and constitution of the executive authority¹². The party system operates in a variety of ways. Democratic governments are elected through parties. Some parties can encourage building coalitions and democracies, while others inhibit it. It is then necessary to characterize them to understand their effects on social, political, and economic life. Additionally, the means that the executive authority holds is important to set up and manage the political agenda, especially for negotiations with the legislative power.

Nature of the party system. Most commonly the literature focuses on two features of party systems, namely fragmentation (number of effective parties) and polarization (ideological differences between extreme parties in the system). While the former is easy to measure, the latter is more difficult. Fragmentation implies difficulties for the executive to coordinate and get support for its legislative programs and can eventually lead to isolation in pushing its or her agenda. Party system fragmentation is more problematic in presidential democracies: while in parliamentary systems the coalitions are built up after the elections and are binding, in presidential system they are formed before the elections and can be easily broken. Parties can be part of the opposition without bringing down the government, and the president can finish his term with little congressional support.

Alternative measures of polarization include the existence of left or populist parties. In non-polarized systems parties are more “pragmatic”, and the relationship between leaders and candidates are instrumental, based on interests to obtain offices more than attached to

¹² For a different classification, based on three different sources of political failures in democracies – bias in

strong ideological fundamentals. Lower degrees of polarization and centered parties imply to some extent lower costs of coordination, while higher costs are associated to high polarization. In the extreme, ideological differences entail unsolved coordination problems. The conflict between strong left parties, such as populist parties and labor movements would make more difficult the reforms (Haggard, 2000). Additionally, polarization combined with fragmentation makes reforms more difficult to implement if combined with fragmentation. Potential large swings between successive elections given the polarization mixed with opportunistic behavior derived from fragmentation can increase the uncertainty and delay of reforms (Alesina, 1987).

An additional feature of the party system is the institutionalization of parties (Mainwaring and Scully, 1995). This characteristic is considered under four criteria: stability in the rules and nature of inter-party competition, stable roots in society, legitimacy of elections and parties, and parties' organization. The more institutionalized the party system, the greater the importance of parties in addressing political demands, and the greater the political stability and predictability. However, the expected effect of this characterization is also ambiguous in the literature. The system should not necessarily move toward hyper-institutionalization. The literature finds only that a very low level of institutionalization produces problems; the message is not that very high levels of institutionalization are necessary or unambiguously desired. (Mainwaring and Scully, 1995). On the other hand, an inchoate party system implies that the needs of the population are expressed through alternative mechanisms –violence, revolution, etc. Due

representation, agency problems and aggregation problems – see IDB (2000).

to the difficulty to measure the institutionalization of parties, especially in what refers to the second criteria (stable roots in society), part of the literature (see, for example, Haggard, 2000) emphasizes in the internal organization of parties, which is addressed in the following subsection.

Internal organization of parties. Organization of parties is important since it influences the response of individual politicians to the demands of their constituencies, vis-à-vis those of the party and the society at large. Weak party leadership, as well as electoral laws that create incentives for candidates to differentiate themselves from each other, would motivate politicians to cultivate personal relationships with their constituency and to represent narrow constituency bases. At the other extreme, strong parties and party leadership would lead the voters to align with the party itself, not the candidates, and each individual candidate would not have incentives to cultivate personal relationships. This implies that parties can focus on broader policies.

According to Mainwaring and Scully (1995), relatively little has been written about the internal organization of parties. For Payne et al. (2002) the best form of measurement is through opinion surveys, which are difficult to evaluate in a systemic basis for the region. However, other authors (Carey and Shuggart, 1995 and Seddon et al.) use measures of electoral laws to calculate the incentives for politicians to adhere to party platforms vs. building support bases in narrow constituencies. Access to the ballot, the system that pools votes among candidates of the same party, and laws that determine the number of

candidates voters can support determine the way candidates manage their electoral campaigns.

Constitution of the executive: Parliamentary vs. presidential systems. Pros and cons of presidential relative to parliamentary systems have been discussed in great details in the literature since the 1980s, without a clear consensus. Initial critics to presidential systems are rooted in three concepts. Separate election of the president and the legislature implies a dual legitimacy, and may results in political stalemate, which may be deeper in countries with bicameral legislatures. Secondly, fixed terms in office may contribute to political instability, and the system can be politically paralyzed for an intolerable period of time. Finally, the presidential election makes a take-all winner, elected with just a bare majority (Payne, et al, 2002). Recent studies, however, have emphasized the advantages of presidential systems (Mainwaring and Shugart, 1997). Balance of powers in the presidential system impede the possibility that the president assumes all power, contrary to the parliamentary system with single party majority, where the winner can assume a dominant position. In presidential systems the legislators have more freedom to debate alternative policy options, since opposition to the government does not endanger the stability of the system. Open debate can also allow the voters to identify policies with parties, a more direct mechanism to hold the government accountable. Additionally, fixed term can also make the presidential system more stable, especially in the context of weak, fragmented, or polarized parties. Finally, although the independence of the legislature could spawn difficult coordination in fragmented environments, the necessity of building coalitions avoids the passing of legislation merely to avoid crises, as could happen in

parliamentary systems. In that sense, check and balances from congressional (or legislative) opposition are more effective in presidential systems.

The efficiency and stability of presidential democracies is greatly influenced by the manner in which tensions between the legislature and the executive are solved. Coalitions in presidential systems are not as binding as the ones required in the parliamentary system. Sometimes parties agree to join forces before the elections, but support is not ensured after the coalition candidate wins. Coalitions to some extent solve the problem of “dual legitimacy”. In Latin America, the unraveling of the traditional parties in some countries, especially in the Andean zone, coalitions have become more and more a necessity for the stability of democracy (Payne, et al, 2002).

The powers that help the executive to manage his political agenda, build coalitions, and implement his policies can be divided in two groups: constitutional powers and partisan powers. The former include legislative powers, some of which are reactive in maintaining the status quo (such as veto power that the president can exert on laws approved by the congress) and proactive in setting up and managing an agenda (such as issuing decrees or the declaration of “urgent” policies to be discussed in the congress to enact legislation). Emergency laws and the possibility to convoke referenda or plebiscites are also constitutional powers. Partisan powers are related to the party support that the president enjoys in the congress, and could be institutional (such as electoral laws and the structure of the party system), or circumstantial (such as the outcome of the elections). It is not sufficient, however, to study the effect of each of these presidential powers separately, as

the key lies in the interaction between presidential powers and party system variables (such as multiparty system, polarization and the ones that determine politicians behavior). For example, even a president with very strong decree powers, if he is facing a highly fragmented congress, will ultimately be constrained in his ability to manage his agenda. Thus, the interaction between constitutional and partisan powers is of vital importance, as will be tested and discussed in the empirical section.

In conclusion, diverse features of the nature of the party system, internal organization of parties, and constitutional powers conceded to the president determine the political structure and help to model the political restrictions that characterize the democratic environment faced by the executive power at the moment of implementing the reforms..

Marketing of Reforms

After characterizing the political restrictions, the next question is centered in the strategies that the reformers should choose to surpass them. How should the reforms be designed to secure legislative approval? This section is dedicated to revise the literature of marketing of the reforms, which is based on two inter related concepts: *speed* and *sequencing* of the reforms. Although the distinction of these two concepts is clear in their definition (see Haggard, 2000), diverse papers in the literature use them indistinctively. However, as will be clear in the discussed in the next section of the paper, the distinction is important at the moment of the empirical tests. *Speed* is related to the way each reform is implemented, either gradually, or with “shock therapy” at a point in time. *Sequence* is related to the way the government draws up the agenda: one reform after another, or all

the reforms bundled into one package (or the “big bang”). In the literature, speed is more related to the economies in transition transformation to market economies (Dewatripont and Roland, 1992a, 1992b, and 1995) while sequencing is more related to the process of reforms in Latin America (Martinelli and Tommasi, 1997; Schamis, 1999). Wei (1997) and other authors combine the two concepts in one: a gradual big bang. The following paragraphs discuss in more detail the theoretical support for each of the roads taken by policymakers in different contexts.

Dewatripont and Roland (1992a and 1992b) advocate gradualism when the agenda-setting government faces the trade off between the costs of compensating losers from the reform and the gains of the optimal path of allocative efficiency. For economies undertaking free market reforms, the transitional cost of privatization would be a higher rate of unemployment in the short run, although in the long term efficiency would increase. Political constraints are introduced through the heterogeneity of the work force in terms of outside opportunities. Asymmetric information problem arises when outside opportunities are private information for each worker. The cost of compensating layoffs could be higher than the gains of efficiency when the reform is undertaken with shock therapy: all the employees would get the same “high” compensation scheme. To solve the asymmetric information problem the reform is divided into two rounds. In the first, only the employees with better outside alternatives would be compensated (they would leave first), and, in the second, the rest of the employees would leave with a lower compensation. Gradualism is preferred to a therapy shock: compensation costs would be lower, and gains in efficiency would eventually be achieved. Gradualism is also

optimal when there is uncertainty about the outcome of the reforms, and reforms are complementary (Dewatripont and Roland, 1995, based on uncertainty model from Fernández and Rodrik, 1991). After the positive outcome of the first -and incomplete- reform, the costs of reversal would be higher than the costs of implementing the second complementary reform. Following this analysis, the least painful reforms with the highest support would be the first to be implemented, while the ones with higher costs would be implemented later. However, this argument could go against the optimal path of reforms, at least in economic terms.

Based on the Latin American experience, according to Tommasi and Martinelli (1997), sequencing is not feasible when each group has veto power and the costs of compensation are higher than the gains from the reforms. Moreover, if no pre-commitment mechanisms exist to achieve the optimal sequence of the reforms, time inconsistency would also advocate the big bang approach.

From the interest groups literature we can also extract strategies used by the reformers. In the same vein of Tornell (1998), Schamis (1999) observes, based also on Latin America, that opponents of the reforms were not just rent-seeking groups that support state intervention and avoid liberalization (as would be the supporters of the communist party in pre-reform economies in transition). The experiences of Mexico, Argentina and Chile show that reforms came about from a coalition built of policymakers and powerful groups that seek rents from the reforms (i. e. privatizations). In that sense, although

building a coalition of “winners” took time (over the course of the decline of the import substitution model), all the reforms were presented in a package.

In his paper Wei (1997) combines the concepts of speed and sequencing: gradualism is defined as a sequential implementation of a minimum set of reforms that are interrelated with each other. In Haggard’s terminology, it is gradualism of big bangs. For Wei, optimally designed sequencing is better than bundling the reforms since it splits the opposition: although a reform could have a positive effect on the population, presenting it on a package would lead to block coalitions that would stop its implementation. In the base of this approach is the heterogeneity between winners and losers of the reforms. Although, theoretically speaking, reforms are presumed to benefit a majority, their implementation with many winners and few losers might be politically difficult. Distortions that affect the economy as a whole, but that have few but powerful beneficiaries interest groups cannot be easily eliminated. Finally, this design could entail time-consistency problems if no pre-commitment mechanisms are present: the support from a group that in the second reform might be hurt is time-inconsistent (Martinelli and Tommasi, 1997).|

Finally, during the “honeymoon” period of new administrations, governments may enjoy higher levels of support. At the moment of setting the agenda, a big bang would be the better strategy since support has been already built.

Advocates and opponents of sequencing reforms describe their results in different environments and under different assumptions of power of groups and political restrictions. With population heterogeneity, although outcome of the reforms is the primary goal, coalition-building strategies present the restrictions that could lead to failure or success in the implementation process. Reformers could be deviated from the reforms' optimal path in order to surpass potential political obstacles in the implementation process.

The Game of Reforms: game theory and hypotheses.

In this sub-section, a dynamic game of complete information is modeled to analyze the strategies used by the reformers facing the political restrictions described so far. The model helps to understand the mechanisms that drive alternative strategies that the executive can use to set the agenda and obtain legislative support.

Stability and efficiency of democracy in presidential systems, and in particular for the implementation of the reforms, is strongly influenced by the way the tensions in the relationship between the executive and the legislative are resolved. The legislative support that the president obtains in the legislature is highly affected by the heterogeneity of the congress, which in turn is based on the party system and the internal organization of the parties.

Coordination and coalitions among groups determine the acceptance or rejections of the reforms. The executive is not a passive actor: as an agenda setter, it is essential to design

strategies to organize winners and compensate losers among the affected groups. Coalition-building and compensation costs will drive the strategies of the president.

Before describing the game, it is to introduce an assumption. At the moment of presenting the reforms, the government has in mind an optimal path, at least in economic terms. For example, if the reforms were labor (l) and trade (t), it would be optimal to first flexibilize the labor market to avoid, or at least diminish, the transitional unemployment that a trade reform can entail between importer and exporter sectors. However, to reach the political-economic equilibrium a deviation from the optimal path in economic terms is necessary: while trade reform can be initialized by decrees that reduce tariffs and open the economy, a labor reform is more complicated in technical and political terms, and its implementation in the congress, especially in a multi-party system, might be unfeasible. In that sense, following Dewatripont and Roland, it can be optimal to implement first the trade reform, and then take advantage of show the complementariness of the labor reform to implement it in the second round. It could be also optimal to present both reforms to the congress, in order to compensate losers from one reform with gains from the other.

The game follows Martinelli and Tommasi (1997). In the extensive form presented in Figure 6, “nature” – or the “third wave” of democratization – determines with the same probability the degree of the heterogeneity in terms of fragmentation, and particularism.¹³

To surpass the obstacles that heterogeneity might impose, compensation cost to

¹³ This term refers to the incentive for the politician to decide how much he must distinguish himself from the rest of the candidates, and the institutional incentives to cultivate personal relationships, and is clearly related to the internal organization of the parties.

coordinate must be taken into account. In the second stage, the executive decides how to present reforms, bundled or separated, and groups will vote in the third stage. There are three parties (A, B, and C) which, with an enough degree of institutionalization, represent three heterogeneous groups with varying preferences for different reforms. The groups could be divided as representing party interests, different constituencies with regional interests or diverse interest groups of the voter population.

Some types of reforms could affect negatively or positively some of the groups' interests. Continuing with the example, the executive is pursuing two reforms, labor (l) and trade (t), with an economically optimal path in terms of the outcome. The government and the society would get a higher payoff if reform t is implemented after l .

The majorities would be obtained in the following way: to carry out l , A and B should coordinate. To implement t , groups B and C should be organized. There are several explanations for this design of the game. For some authors, although the groups hurt by the reforms are clearly identified, the cost of coordination of the beneficiaries is high and the beneficiary groups are diffuse or represented by different minorities (Fernandez and Rodrik, 1991). On the other hand, the agenda setter can obtain a majority compensating the groups that are hurt by the reforms, through, for example, budget allocations. This compensation mechanism would disorganize and separate blocking coalitions (Wei, 1997).

The driving force of the game is the cost of forming coalitions to comprise a majority. The payoffs of the model are designed taking into account the benefits of the reform for each group –or the coalition and the remaining group- and for the government. The coordination costs that the government or the groups would pay in order to implement the reform are also included.

In the left side of Figure 6, after the first stage when “nature” has shaped the structure of political institutions, the government decides how to present the reforms. To pursue the optimal path, the government must pay the coalition cost to *A* and *B* in the first stage (implementing reform *l*), and then to *B* and *C* to implement reform *t*. Solving backwards, in the last stage, if the government does not pay the cost, the reform will be rejected (there is no coalition to pass it), inducing the group outside the coalition to reject the first reform in the second stage. The best outcome would therefore be the status quo –which is negative, assuming the reforms are following on the heels of a crisis and should not be delayed. If the cost is paid in the third stage, even though both groups are going to have a positive outcome, the losses of the government would not compensate for the gains from the reforms, and it would be better to bundle the reforms.

If the reforms are bundled, groups that stand to lose would be compensated with the other reforms, and the government is not going to pay any cost to build coalitions¹⁴. If the cost of coordination is low, the optimal path could be obtained (see right panel of Figure 6). In that case, the costs of identifying and organizing winners and losers would be lower than

remaining with the status quo. Pre-commitment mechanisms, or lower costs of coalitions in the two stages, allow the government to reach the optimal path, under a majority-voting environment.

The first hypothesis to be tested empirically can be derived from the game. A high degree of fragmentation entails bigger costs of coordination, forcing the government to sacrifice the optimal path and present to the congress the reforms in a package. The same argument can be used for polarization: strong polarization and ideological opposition between parties raise the costs of coordination. For different reasons, higher levels of particularism would have the same effect. Fewer party-aligned candidates and more incentives to differentiate themselves from the other candidate of the same party would make negotiations for majorities more difficult. The big bang approach would then compensate the losers and organize majorities in a less costly way. This does not imply, however, that lower levels of particularism are desirable. Seddon and Stein (2000), organization of parties that balance the demands of parties and constituencies (i.e. intermediate levels of particularism) are more likely to affect positively the recovery from a crisis, and for Panizza (2000) intermediate levels are associated with a higher quality of government's institutions. This is a second hypothesis to be tested in relation to the marketing of the reforms.

¹⁴ It is then assumed that the presentation of the reforms in a package would imply that winners and losers

Hypotheses and Econometrics Results

Hypotheses

Following the description made so far about the relationship between the executive and the legislature, the main hypothesis to test are the effects of fragmentation, polarization and particularism on the way the reforms were implemented. It is expected that when fragmentation and polarization are high, the executive would present the reforms bundled. For particularism, the reaction of the executive facing electoral laws that incentive politicians to cultivate personal relationships with the voters would be to bundle the reforms in order to get better coordination and surpass the political restrictions to implement the reforms. Following Gaviria, et al. (2000), a moderate level of particularism would imply better possibilities of coordination, and the optimal path of the reforms can be pursued. Another measure of particularism is the district magnitude, although its effect is not clear. On one hand, according to Seddon et al., larger district magnitude would diffuse electoral competition, inducing parties to seek support from broad coalitions, while smaller districts would limit the competition to narrow geographical constituencies. On the other hand, larger district magnitude would increase the competition for candidates that would need to differentiate from each other to attract voters. The effect that dominates needs to be tested empirically.

The interaction between fragmentation and polarization (Alesina, 1987 hypothesis) and between presidential powers and party system organization (Mainwaring and Shugart, 1997 and Payne, 2002 hypotheses) are also tested. The effect of the decree power that

could coordinate and build coalitions by themselves, without any government intervention.

facilitates the president to manage his agenda is expected to be positive, while the effect of veto powers is expected to be not significant, since this power is useful to maintain the status quo. Finally hypotheses related to the crisis as the trigger for the reforms (Rodrik, 1996), and compensation mechanisms are also tested in the model.

Reforms and Political Variables: Description and Sources

Reforms index: The variable used is the index of structural reforms by Lora (2001). This index is constructed with policy variables from the following five areas: (i) trade, (ii) financial policy, (iii) tax, (iv) privatization, and (v) labor. Some of these variables are related to legislation (such as labor, where what is used is the legislation on firing and hiring costs, or trade, which includes the level and the dispersion of tariffs), while others include policies (such as privatization, which measures the dollar amount of public goods that were privatized). The index is calculated for each particular reform, comparing each country’s *i* status of the reform with the rest of the countries of the region in any year, and normalizing with the total difference, following the formula:

$$index_{it} = \frac{\max reform - reform_{it}}{\max reform - \min reform}$$

Then the total index is the average index of the five areas. For a complete description of the components of the index, please see the appendix 1. Table 3 presents the total index for each, and the average for the region.

<<Insert table 3>>

Political Variables: The sources for political variables are the DPI database of the World Bank for fragmentation and polarization, Seddon et al. (2001) for the index of particularism, and Payne et al. (2002) for presidential powers.

Fragmentation is measured as the probability that two deputies picked at random from the legislature will be of different parties.

Polarization is the absolute number of the greatest difference between two parties, classified as -1 for left parties (communist, socialist, social democratic or left-wing), 0 for the centered ones, and $+1$ for the right ones (conservative, Christian democratic, or right-wing). The absolute value of the difference ranges from 0 to 2 , where 2 corresponds to the greater polarization.

Particularism measures come from Sedon et al., and refer to the electoral laws and internal organization of parties' incentives that determine politicians' behavior. This index ranges between 0 and 2 , where 2 refers to the higher incentives for the politicians to cultivate relations with narrow constituencies. Their index, called index of "particularism", include measures for "ballot", the strength of parties and citizenships to shape candidates' access to the ballot with a possibility to be elected. For this component of the index, particularism, or the degree of candidates' incentives to cultivate personal relationships with voters and to represent narrow constituencies, is lower when parties control access to the ballot and voters cannot disturb the party's list. The second criterion is "pool", which measures the way votes are pooled among candidates in the same party.

Particularism is lower if votes contribute only to the candidate's political career, not to the other candidates of the same party. Finally, "vote" measures the number of candidates that a voter can support. If voters can vote for a party, not for a particular candidate, particularism is lower.

Presidential powers: Measures of decree and veto powers come from Payne et al. (2002). These variables range from 0 to 4, where 4 refers to the higher level of the correspondent power. The president with broad decree powers (not just the ones delegated by the congress) that have long-term effects and that cannot be rescinded by the congress has a 4. Veto powers with no override by the congress also correspond to a 4 in the index.

Table 4 presents the political variables by country and the simple average for the region. The values presented suggest that there are between 2 and 3 parties in the region: Fragmentation for the region is 0.61, with a minimum of 0.53 and a maximum of 0.68. Polarization is more dispersed within countries, with a mean for the region of 1.32, which suggest a "centered" region, but with minimums and maximums of 0.68 and 1.89 respectively. Particularism measure suggests that in the region the incentives to cultivate personal relationships are lower, except for the countries with parliamentary systems (Jamaica and Trinidad and Tobago): the mean is 0.51, with minimum and maximum lower than 1 (0.6 and 0.85 respectively). Finally, decree and veto powers are also low for the region. The only country with complete decree powers is Brazil, while none of them

holds complete veto powers. Additionally, veto powers are higher than decree powers: the regional mean for decree powers is 0.65, while for veto is 1.65.

<<Insert table 4>>

Methodology and Results

Unavailability of time series data for some of the political variables, especially the ones related to presidential powers, do not allow fixed effects estimation. Other variables, such as the index of particularism vary just for a few countries in the period of study. Random effects is then method used in this study. This method also allows capturing idiosyncratic heterogeneity within countries with dummy variables.

The first variable used as a proxy of the implementation of the reforms is the average of the structural index for the five areas. The estimations presented in Table 5 report the effects of political variables on the path of reforms. The first column confirms the main hypotheses derived from the literature and made explicitly in the dynamic game. Higher levels of fragmentation, higher degrees of polarization, and moderate incentives of particularistic relationships are related to higher levels of reform. Although the result may seem contradictory to the intuition, a closer inspection leads to a different interpretation. What would be expected is that, since fragmentation is an *obstacle* for the reforms, the higher the obstacle, the lower the reform. However, since this is an *ex-post* evaluation, the results show that the reformers indeed followed the strategy. In the countries where the political restrictions are more binding, deeper reforms were undertaken. The results

suggest that facing higher political restrictions reformers decided to pursue deeper and more ambitious reforms. This is the strategy identified by the literature in order to obtain the necessary support from the legislature. The analysis of these results lead also to questions about the deepness and scope of the reforms compared with the initial package presented to the congress. Following Rodrik (1989) argument, a plausible hypothesis to study is related to the credibility of the reforms, where the government, in order to show its “true” type needed to present a more ambitious reform program, especially in more politically fragmented and unstable countries.

<<insert table 5>>

On the other hand, the hypothesis about the crisis as the trigger of the reforms is also established, in particular when crisis is measured as currency one (columns 1 and 2 in Table 5). Reforms are deeper where the crisis is longer. This result is related to the idea expressed by Rodrik (1996) and others in the sense that deep recession makes room for a package of more ambitious reforms presented to the legislature and implemented.

The hypothesis of the interaction between fragmentation and polarization stated by Alesina (1997) is not confirmed empirically (Column 3). The effect of the interaction is not significant and there is not an additional effect of polarization and particularism on the way the reforms were undertaken.

The effects of presidential powers are also significant and with the expected sign (see columns 4 through 7). Decree power affects negatively the level of reforms: since it is a

proactive power to manage the agenda, it helps the president to pursue the optimal path. The effect of the interaction is negative, suggesting that decree power could upset the political restrictions.

The effect of the additional measure for particularism, district magnitude, suggests that for larger it encourages competition and incentive the candidates to differentiate from each other (column 9 in Table 5).

Finally, devaluation is included as a proxy for compensation mechanism, especially to facilitate trade reforms. The use of compensation mechanisms is another strategy to surpass political restrictions with the advantage that it can help to follow the optimal path. The empirical result confirms that hypothesis (column 10): devaluation is associated with a lower path of the reform.

Bundling

To measure if the reforms were bundled, the unit of time is a presidential period for each country, getting three presidential periods for the whole sample¹⁵. Then, changes of each reform index for the five areas are chosen when they are greater than one standard deviation of the index during the whole period. Finally, the number of times that a change is chosen is added for each presidential period, creating a categorical variable of bundling. For example, for Argentina 4 out of the 5 indexes of the reforms changes are greater than one standard deviation in 1990 and 1991, years that are included in the second presidential period. It means that for Argentina the bundling measure has a value

of 4 in that presidential period, and it is one of the countries where the reforms were bundled. This measure is then averaged for the whole period in order to create a cross section database with a bundling measure. It is not necessary to calculate bundling per period, since the political variables have very small changes in time. However, the trade off is in the degrees of freedom, since the database just includes 19 countries.

Column 11 in Table 5 shows the results for this measure of bundling. Although fragmentation, particularism and crisis coefficients have the expected sign, only fragmentation is statistically significant, confirming just partially the hypotheses. Additionally, polarization is significant but with the opposite sign, suggesting an alternative hypothesis: high polarization implies that it is easier to identify and organize winners and losers, facilitating coordination.

However, two arguments, one technical and one theoretical, can dampen down the expected results. The technical argument is the unavailability of larger databases to do estimations with some degree of confidence. The theoretical one refers to the definition of bundling. The indexes of structural reforms measure changes in legislation, or the change on policies at the moment they were undertaken. Bundling refers to the way the reforms were presented to the congress, but information about how they were discussed is not available. The indexes cannot take into account the way the reforms were presented and discussed in the political scene. This argument follows hypotheses proposed by in the literature by Tornell (1998) and Schamis (1999). For these authors, reforms are politically

¹⁵ The source for presidential periods is the Political Database of the Americas:

endogenous and were discussed or generated by the elite during a long time during the recession period, although implemented in a small period of time.

Conclusions

In the paper hypotheses from different parts of the political economy literature are combined and organized using game theory. The game is useful to model the political restrictions faced by the reformers, to understand the driving forces of the discussions in the congress, and to derive hypotheses to be tested empirically. In the empirical section aggregated variables panel organized are used to estimate those hypothesis, finding the expected results. Fragmentation, polarization, and particularistic political variables determine to some extent the path of the structural reforms, and the crisis of the 1980s seems to be the trigger of the reforms.

Deeper questions about the way the reforms were undertaken arise from these aggregated estimations. To reach the political economic equilibrium, a deviation from the optimal path could lead to sub-optimal equilibriums. A question arises then about the quality of the reforms in the way they were finally attained. If the economic path is not optimal in political terms, how far the reformers should deviate to obtain the necessary support? Was it possible to design reforms that could arrive to a better equilibrium than the one reached with the political restrictions? Although the work with aggregated data is not finished, these questions suggest that microanalysis and case analysis is needed, in

particular to study how the political process could have changed the reforms designed and presented in technical terms.

Appendix 1 Data Sources

Reform Index

The *Reform Index* is a simple average of indices of policies in the following five areas: (i) trade policy, (ii) financial policy, (iii) tax policy, (iv) privatization, and (v) labor legislation, from Lora (2001). Involved in each of these areas may be one or more basic indices, which are averaged out. Each of the basic indices may move in a range of 0 to 1, where 0 corresponds to the worst reading for any year and any country in the period and the countries considered, and 1 to the best. The basic indices that make up each area have been listed in the text. A detailed description of this index is in Lora (2001). This section enumerates the different variables used to construct the index.

Trade: Information for average tariffs (including surcharges) and their dispersion for from an OAS research project headed by José Echavarría, covering the years 1986, 1988 and 1990. Intermediate years were interpolated, IADB, Department of Integration and Regional Programs, and starting in 1992 *World Development Indicators*- World Bank.

Financial: Average of three indicators (i) Reserve ratios indicator, calculated with information on bank reserves and demand deposits from *International Financial Statistics Yearbook*, IMF, various issues. (ii) Indicator of interest-rate freedom and other dimensions of lending agreements. It is the product of multiplying a generalized control dummy variable by a variable of the freedom granted to the banks in eight dimensions of their lending operations: currency in which credit is denominated, loan repayment periods, amortization system, interest payment system, maximum level of ordinary interest rates on loans, maximum level of interest rate for overdue loans, obligatory investments (other than reserves), and minimum ratios of allocation of credit to specific sectors. Source: survey by the IDB's Research Department of Central Banks and Superintendencies of Banks in Latin America and the Caribbean to construct the interest rate control variable. Dimensions of lending agreements in which governments intervene come from a survey of banking associations in the countries taken by the IDB and FELABAN in January 2000. (iii) Prudential regulation quality indicator, the product of a variable dummy of application of the Basle minimum criteria on capital requirements, by a variable of the application of four complementary norms: adjustment of capital requirements according to risk, deduction from capital of the value of defaulted loans, deduction from capital of the value of unrealized losses from portfolio investments, and deduction of capital of losses because of exchange rate fluctuations. Source: Barth *et al.* (2001).

Taxes: For the 1985-89 period, the source is Coopers and Lybrand, *International Tax Summaries*, various issues, and Price Waterhouse, *Individual Taxes: A World Wide Summary*, and *Corporate Taxes: A World Wide Summary*, several issues. For the 1990-95 period, CIAT (Inter-American Centre for Tax Administrators), *Estructura y Administración de los Impuestos sobre Rentas y Ventas en Países Miembros del CIAT*. For the years after 1995 links provided by Flinders University International Tax Index (<http://commerce.flinders.edu.au/InternationalTax/>) were consulted. Productivity

indicators of direct taxes and the VAT calculated using data on collection in the *Government Financial Statistic Yearbook*, IMF, various years.

Privatization: Dollar amounts of privatization from World Bank International Economics Department and *Privatization International*, various years. The cumulative amounts of privatization each year are expressed as a proportion of GDP in current dollars for that year. The GDP series: CD-ROM World Development Indicators (2000) published by the World Bank.

Labor: Four indicators (i) Flexibility of legislation on hiring. This indicator takes the value of 1 when the legislation does not impose restrictions on temporary contracts, the value of 0.5 when only contracts with a limited duration and renewability are allowed, and 0 when temporary contracts are limited to temporary functions. Source: legislation of countries as reported in IDB (1996), and complemented for subsequent years with information from Labor Ministries. (ii) Expected cost of laying off a worker, which comes from Heckman and Pagés (2000). (iii) Indicator of work-day flexibility, which takes the value of 1 when extra charges for overtime are not over 50% and for holidays are not over 100%, and the value of 0 when both overtime and holidays have extra charges of over 100%, and the value of 0.5 in remaining cases. (iv) Cost of social security contributions in pensions, health, family compensation and unemployment Source: *Social Security Programs Throughout the World*, U.S Department of Health and Human Services.

Political Database

Fragmentation and Polarization: Database of Political Institutions (DPI)¹⁶ from the World Bank. This database contains 177 countries for the period 1975-1997, and data for five different groups: Chief Executive Variables, Party Variables in legislature, Variables detailing the legislature, Electoral Rules, and checks and balances.

For Polarization the database has measures about the orientation of the executive party and the biggest opponent party. There is also a specific measure of polarization with center = 0, right = 1 and left = -1.

For fragmentation the database has variables such as time since formation of the executive party, the control of relevant houses, number of seats held by the executive party and by the opposition, and measures such as the probability that two deputies picked at random will be of different parties.

Internal organization of parties – Particularism Index: The index of political particularism is constructed as an average of three components: ballot, pool and vote. The source is paper by Gaviria et al (2001), and comprises 155 countries for the period 1978-1997, relying on the Inter-Parliamentary Union's (IPU) annual Chronicle of Parliamentary Elections and Developments, online Parline database and International

¹⁶ See Beck et al (2000)

IDEA Handbook of Electoral System Design, and the Manual de los Partidos Políticos de América Latina in cases where the IPU information was not complete.

Ballot: describes relative strength of parties and citizens in shaping candidates' access to the ballot and a plausible chance to be elected, with two dimensions of party control over politicians' futures: control over party endorsements and control over ballot rank in electoral list systems. A code of zero means that voters can only choose a party and cannot demonstrate a preference for any individual; a code of one means that voters can choose among a limited set of candidates, and; and code two refers to low party control where candidates can enter the ballot and plausibly win without party nomination or imposition of order.

Pool: Measures the extent to which a candidate can ride his party's reputation to electoral success. A score of zero if votes cast are pooled across the whole party to determine the allocation of seats, one if votes are pooled at the sub-party level, and two if votes cast for a candidate contribute only to that candidate's electoral success. In standard economics language, a high value of pool means that the electoral success of a given candidate does not produce any positive externality for other candidates of the same party. At the same time, a low value of pool means that there are large externalities.

Vote: Measures limitations on the number of individuals that voters can support. The values range from zero for a single vote for a party, one for multiple votes across candidates who may or may not have to be from the same party, and two for a single vote for a single candidate.

Additional variables are **District Magnitude** and **Proportionality**, also from Gaviria, et al (2001), using data from Parline online database and the International Parliamentary Union's Annual Journal. District Magnitude is an increasing index measured from the point of view of the legislator. Proportionality is the proportion of legislators from a national constituency.

Constitutional powers: Source is Payne (2002). For decree power, it is a category variable that varies between 0 and 4. A value of 0 corresponds to a complete lack of decree power and when the constitution either forbids or does not address delegation of decree authority from the congress to the president. A value of 4 is related to broad decree powers for the president that cannot be easily rescinded by congress, and that can have long term effects. Values of 1 and 2 correspond to intermediate decree powers, when the constitution expressly states that congress can delegate legislative powers to the president, and in the case where non delegated decree power can be issued by the president, but for a limited period of time and/or can be rescinded by the congress, or just issued under emergency circumstances.

Crisis Variables

Currency Crisis: Frankel and Rose (1996) define "currency crash" as a nominal devaluation of the currency of at least 25 percent that is also at least a 10 percent increase

in the rate of depreciation. Their estimates cover the period between 1971 and 1992 for 105 countries.

Banking Crisis: Caprio and Klingebiel (1999) measure 114 episodes of Banking crisis in 93 countries during the period 1970-1999.

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Table 1
Developing Countries Per Capita Growth Rates, By Region

	1965-73	1973-1980	1980-1989
All Developing Countries	3.9	2.5	1.6
SubSaharan Africa	2.1	0.4	-1.2
East Asia	5.3	4.9	6.2
South Asia	1.2	1.7	3.0
Latin America and the Caribbean	3.8	2.5	-0.4

Source: Krueger (1993)

Table 2
Type of Reformers

		1985	
		Above the average (A)	Below the average (B)
1999	Above the average (A)	Chile, Trinidad & Tobago, Guatemala, Jamaica	El Salvador, Paraguay, Uruguay
	Below the average (B)	Argentina, Bolivia, Brazil, Peru	Colombia, Mexico, Costa Rica, Ecuador, Venezuela

Source: Author's calculation using data from Lora (2001)

Table 3
Structural Reforms Index

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Argentina	0.338	0.326	0.327	0.311	0.366	0.468	0.551	0.574	0.602	0.598	0.595	0.597	0.607	0.604	0.616
Bolivia	0.290	0.348	0.390	0.406	0.403	0.466	0.487	0.485	0.474	0.475	0.614	0.711	0.705	0.699	0.690
Brazil	0.259	0.301	0.301	0.344	0.419	0.430	0.431	0.449	0.468	0.489	0.515	0.530	0.551	0.580	0.610
Chile	0.488	0.512	0.513	0.549	0.580	0.570	0.572	0.564	0.565	0.570	0.577	0.586	0.585	0.585	0.606
Colombia	0.291	0.386	0.386	0.383	0.383	0.413	0.477	0.540	0.525	0.534	0.524	0.529	0.555	0.560	0.562
Costa Rica	0.306	0.387	0.428	0.421	0.420	0.425	0.420	0.440	0.446	0.453	0.536	0.533	0.542	0.557	0.557
Dominican Rep.						0.384	0.378	0.432	0.436	0.447	0.439	0.441	0.454	0.490	0.599
Ecuador	0.309	0.317	0.320	0.321	0.323	0.405	0.399	0.456	0.461	0.484	0.536	0.535	0.539	0.536	0.528
El Salvador	0.349	0.353	0.351	0.348	0.362	0.399	0.401	0.416	0.494	0.505	0.488	0.497	0.489	0.572	0.566
Guatemala	0.344	0.344	0.410	0.425	0.447	0.445	0.444	0.450	0.462	0.475	0.513	0.505	0.509	0.570	0.592
Honduras					0.354						0.489	0.500	0.490	0.540	0.511
Jamaica	0.397	0.410	0.494	0.495	0.498	0.500	0.524	0.549	0.539	0.545	0.554	0.557	0.586	0.652	0.666
Mxico	0.290	0.308	0.340	0.392	0.403	0.424	0.453	0.479	0.474	0.540	0.531	0.500	0.510	0.501	0.511
Nicaragua										0.574	0.574	0.580	0.623	0.617	0.598
Paraguay	0.355	0.351	0.350	0.348	0.371	0.437	0.510	0.542	0.555	0.562	0.563	0.562	0.564	0.563	0.566
Peru	0.279	0.313	0.308	0.295	0.286	0.335	0.399	0.459	0.526	0.590	0.598	0.632	0.625	0.643	0.659
Trinidad and Tobago	0.520	0.515	0.521	0.533	0.538	0.567	0.548	0.539	0.540	0.628	0.640	0.640	0.626	0.625	0.631
Uruguay	0.369	0.346	0.345	0.363	0.361	0.372	0.375	0.434	0.437	0.442	0.451	0.452	0.460	0.460	0.477
Venezuela	0.284	0.270	0.270	0.265	0.289	0.343	0.370	0.384	0.461	0.480	0.477	0.504	0.501	0.516	0.514
Average	0.341	0.360	0.377	0.384	0.399	0.436	0.455	0.484	0.503	0.522	0.539	0.548	0.554	0.573	0.583

Table 4
Political Variables

Country	Fragmentation				Polarization				Particularism				Presidential powers	
	Mean	Standard Deviation	Minimum	Maximum	Mean	Standard Deviation	Minimum	Maximum	Mean	Standard Deviation	Minimum	Maximum	Decree	Veto
Argentina	0.61	0.04	0.55	0.67	1.5	0.5	1.0	2.0	0.0	0.0	0.0	0.0	1.0	2.0
Bolivia	0.75	0.04	0.70	0.80	0.5	0.7	0.0	2.0	0.0	0.1	0.0	0.3	0.0	2.0
Brazil	0.77	0.12	0.58	0.88	0.6	1.0	0.0	2.0	1.2	0.0	1.2	1.2	4.0	1.0
Chile	0.81	0.01	0.80	0.81	0.8	1.0	0.0	2.0	0.0	0.0	0.0	0.0	1.0	2.0
Colombia	0.57	0.04	0.50	0.63	2.0	0.0	2.0	2.0	0.7	0.0	0.7	0.7	2.0	1.0
Costa Rica	0.57	0.01	0.56	0.59	1.5	0.9	0.0	2.0	0.0	0.0	0.0	0.0	0.0	1.5
Dominican Rep.	0.58	0.26	0.55	0.61	0.4	0.8	0.0	2.0	0.7	0.0	0.7	0.7	0.0	2.5
Ecuador	0.85	0.02	0.81	0.87	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.0	3.0
El Salvador	0.65	0.04	0.60	0.70	1.2	0.8	0.0	2.0	0.0	0.0	0.0	0.0	0.0	2.5
Guatemala	0.72	0.09	0.63	0.86	2.0	0.0	2.0	2.0	1.3	0.0	1.3	1.3	1.0	2.5
Honduras	0.52	0.01	0.51	0.55	2.0	0.0	2.0	2.0	0.0	0.0	0.0	0.0	1.0	1.5
Jamaica	0.21	0.16	0.00	0.40	2.0	0.0	2.0	2.0	1.7	0.0	1.7	1.7	na	na
Mexico	0.52	0.12	0.33	0.61	2.0	0.0	2.0	2.0	1.4	0.1	1.3	1.5	0.5	2.0
Nicaragua	0.56	0.03	0.52	0.64	1.8	0.6	0.0	2.0	0.2	0.5	0.0	1.3	0.0	1.0
Paraguay	0.52	0.05	0.48	0.60	1.4	1.0	0.0	2.0	0.0	0.0	0.0	0.0	0.0	1.0
Peru	0.64	0.07	0.57	0.77	1.7	0.8	0.0	2.0	0.0	0.0	0.0	0.0	2.0	1.0
Trinidad & Tobago	0.38	0.19	0.16	0.57	2.0	0.0	2.0	2.0	1.7	0.0	1.7	1.7	na	na
Uruguay	0.69	0.02	0.66	0.71	0.8	1.0	0.0	2.0	1.3	0.0	1.3	1.3	0.5	1.0
Venezuela	0.64	0.05	0.57	0.75	0.9	1.1	0.0	2.0	0.0	0.0	0.0	0.0	0.5	0.5
Average	0.61	0.07	0.53	0.68	1.32	0.53	0.68	1.89	0.53	0.03	0.51	0.60	0.85	1.65

Table 5
Total Index of Reforms: Panel Data Regression Results

Independent variables	Dependent variable:											
	Total Index (0-1)										Bundling	
	Reg 1	Reg 2	Reg 3	Reg 4	Reg 5	Reg 6	Reg 7	Reg 8	Reg 9	Reg 10	Reg 11	
Political Variables												
Fragmentation												
Fragmentation	0.46 (4.91)***	0.45 (4.62)***	0.46 (4.51)***	0.69 (5.16)***	0.81 (5.84)***	0.70 (3.43)***	0.69 (5.16)***	0.52 (3.90)***	0.38 (4.59)***	0.28 (3.15)***	3.02 (2.78)**	
Polarization												
Fragmentation*polarization	0.02 (2.53)**	0.02 (2.45)**	0.04 (0.64) -0.02 (0.21)*	0.01 (1.29)**	0.02 (2.20)**	0.01 (1.24)***	0.01 (1.29)***	0.02 (2.25)**	0.03 (3.50)***	0.02 (3.09)***	-0.50 (2.94)**	
Particularism												
Particularism Index	1.25 (5.32)***	1.26 (5.13)***	1.24 (5.23)***	1.19 (5.02)***	1.21 (5.20)***	1.19 (4.98)***	1.18 (5.00)***	1.24 (5.46)***	1.21 (5.75)***	1.23 (5.99)***	0.75 (1.71)	
Particularism ²	-0.57 (3.12)***	-0.63 (3.40)***	-0.56 (3.00)***	-0.40 (2.08)**	-0.34 (1.80)*	-0.40 (1.89)*	-0.35 (1.79)*	-0.52 (2.77)***	-0.61 (4.75)***	-0.65 (4.06)***	-0.42 (1.44)	
District Magnitude									0.01 (2.51)**			
Presidentialism												
Decree Power				-0.28 (3.42)***	-0.30 (3.68)***	-0.28 (3.30)***	0.08 (2.52)***					
Decree*Polarization					-0.02 (2.66)***							
Decree*Fragmentation						-0.01 (0.09)						
Decree*Particularism							-0.25 (4.32)***					
Veto power								0.14 (3.90)***				
Crisis and compensation												
BOP crisis	0.06 (2.37)**		0.06 (2.34)**	0.06 (2.43)**	0.05 (2.28)***	0.06 (2.42)***	0.06 (2.43)***	0.06 (2.53)**	0.06 (2.41)**	0.06 (2.72)**	0.89 (0.35)	
Banking Crisis		0.00 (0.93)										
Devaluation										-0.01 (1.97)*		
R²	0.53	0.52	0.53	0.53	0.55	0.53	0.53	0.57	0.59	0.63	0.53	
No. of observations	175	168	175	162	162	162	162	162	168	152	15	

Notes: Absolute z value in parentheses. For Reg 10, absolute t-statistic is reported.

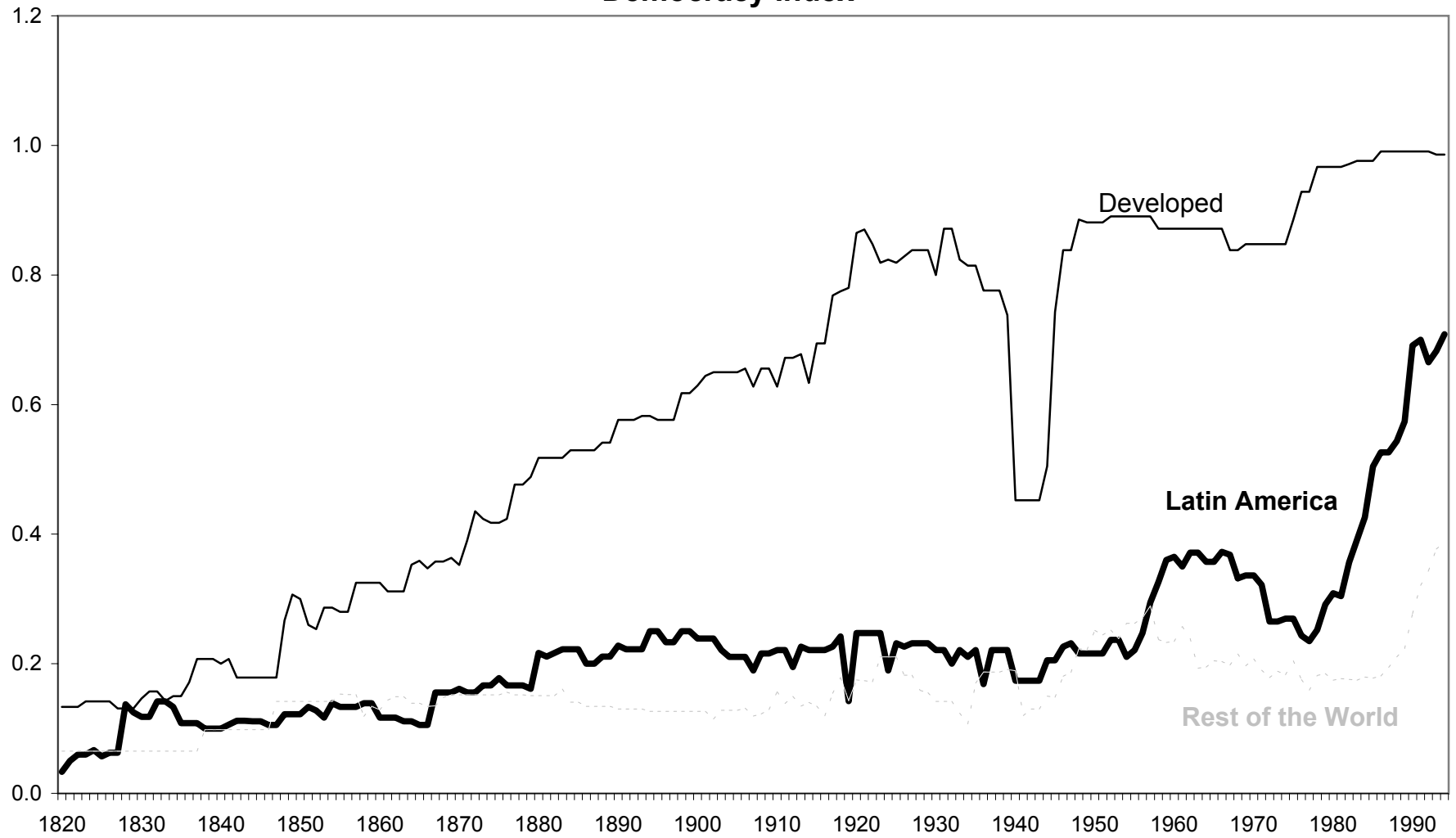
Dummy variables by country and one for parliamentary systems (Jamaica and Trinidad and Tobago) are included in each regression but not reported, as well as the constant term, a trend, and the initial valued of the index for each country.

* Significant at the 10% level.

** Significant at the 5% level.

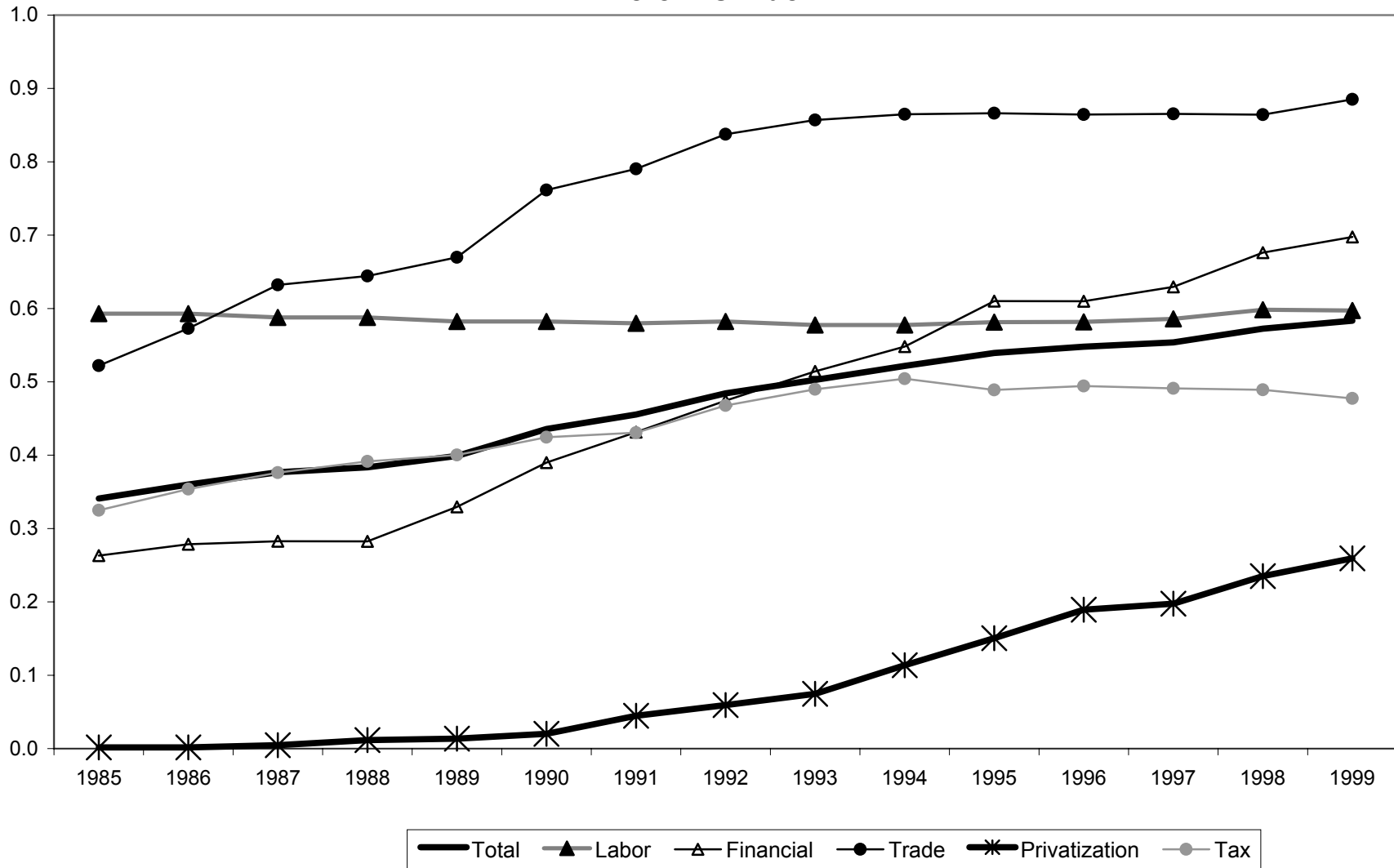
*** Significant at the 1% level.

Figure 1
Democracy Index



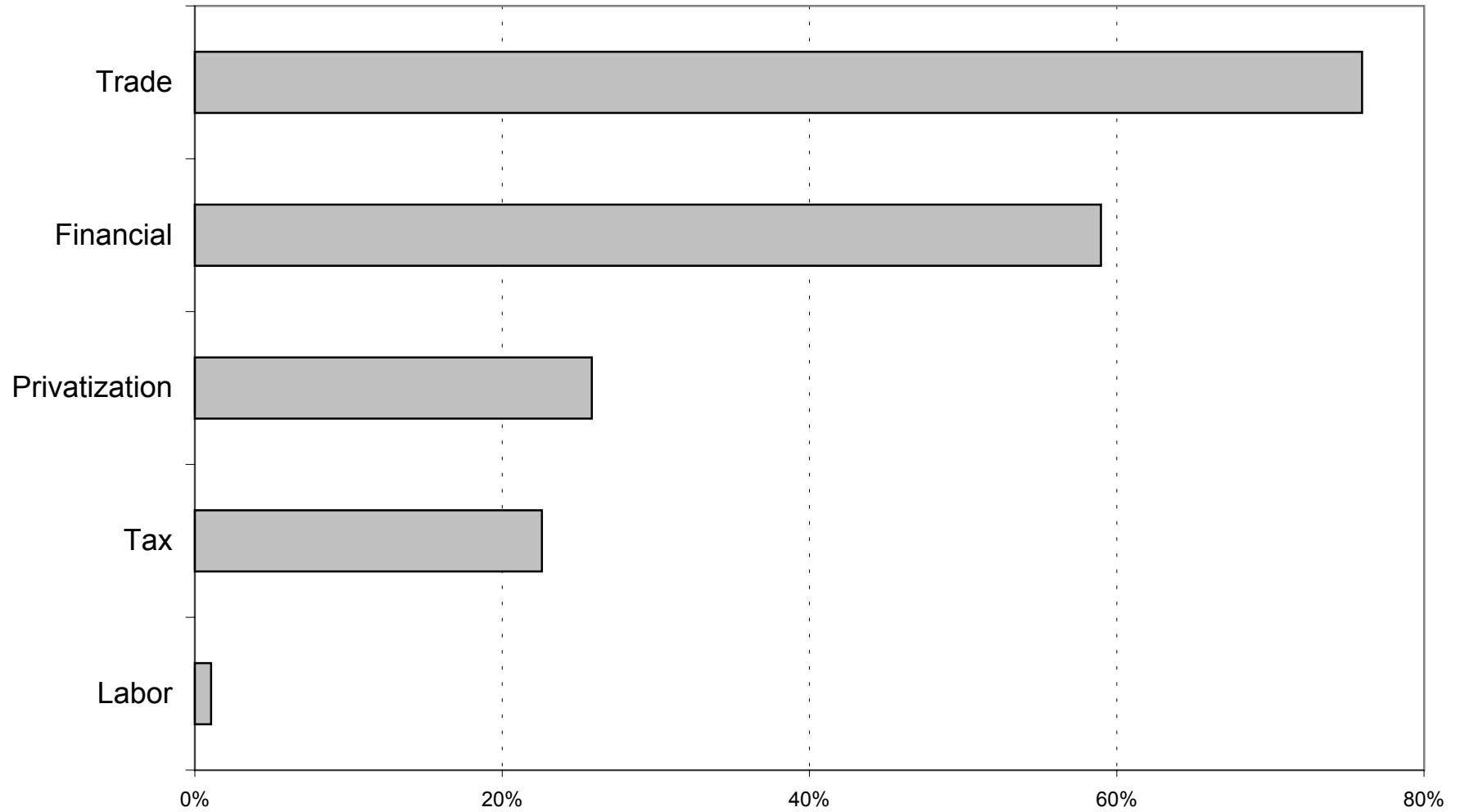
Source: Freedom House

Figure 2
Reforms Index



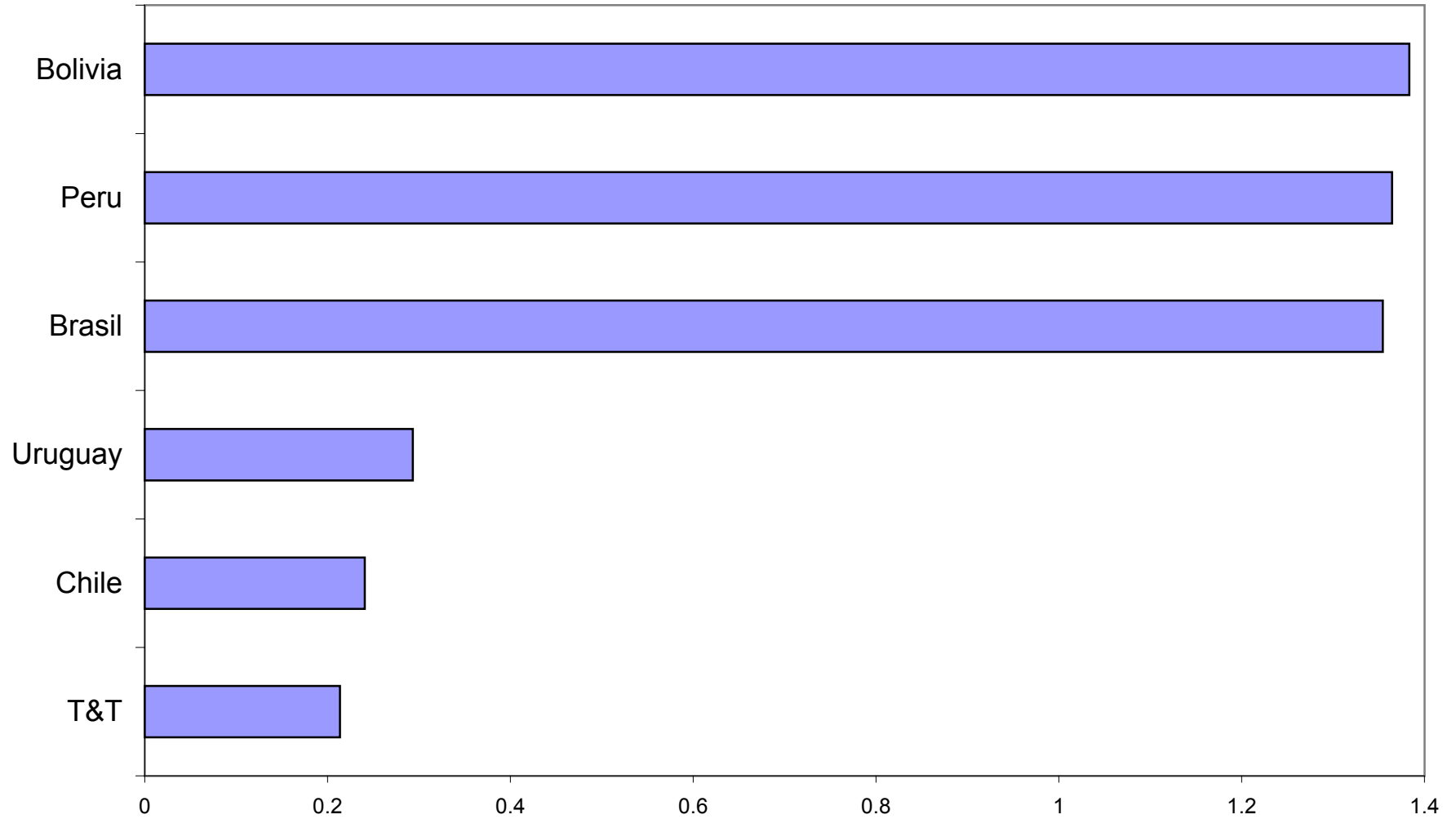
Source: Lora (2001)

Figure 3
Progress of Reforms



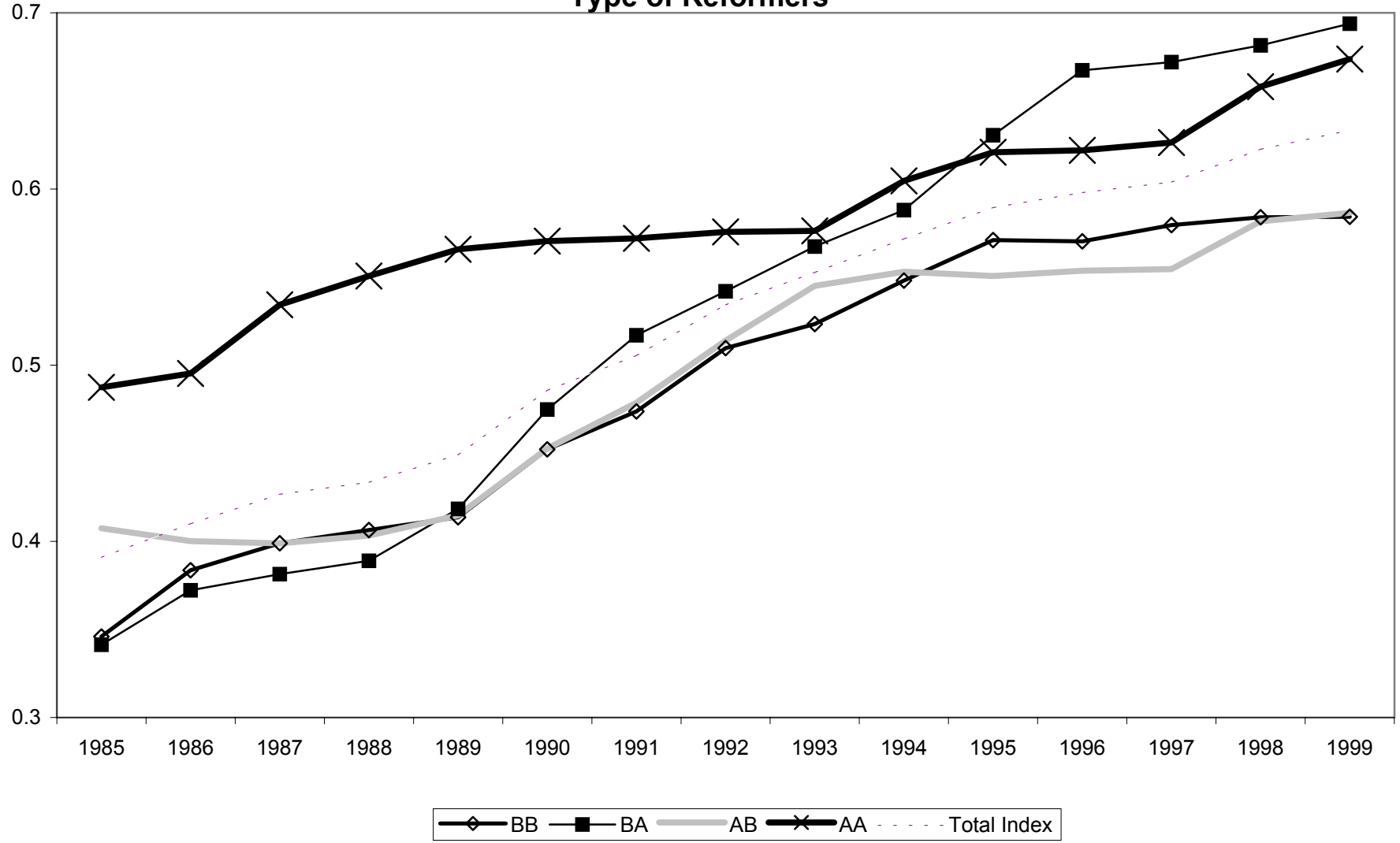
Source: Author's calculation. The progress is measured as the change in index between 1999 and 1985 divided by (1-index in 1985)

Figure 4
Higher and Lower Reformers
(as percentage of original index)



Source: Author's calculation

Figure 5
Type of Reformers



Source: Author's calculation

Figure 6

**Dynamic Game of Complete Information
Fragmentation, Particularism, and
Polarization**

- Gain per group = 1.2
- Cost per group = 0.7
- Lost per group = 1
- Payoffs:
(Government, Coalition, Other party)

- Two Reforms: *l* and *t*
- Three Groups: *A*, *B* and *C*
- Vote: Majority
- Optimum path: *l*, then *t*
- Status Quo: Deterioration
- To pass *l*: coordinate *A* and *B*
- To pass *t*: coordinate *B* and *C*

